80-1211

No.

Supreme Court, U.S.
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IN THE

# Supreme Court of the United States

October Term, 1980

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GENERAL PORTLAND CEMENT COMPANY,
*Petitioner,*

v.

UNITED STATES OF AMERICA,
*Respondent.*

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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BUFORD P. BERRY
EMILY A. PARKER
2300 Republic National
Bank Building
Dallas, Texas

*Counsel for the Petitioner*

## QUESTIONS PRESENTED

1. Whether, in applying the proportionate profits method to determine gross income from mining under section 613(c) of the Internal Revenue Code of 1954, 26 U.S.C., General Portland's first marketable product is bulk cement and does not include cement sold in bags.

2. Whether the additional charge for cement sold in bags (the "bag premium"), the cost of the bags and the cost of packing and loading the bags should be excluded in applying the proportionate profits method to determine General Portland's gross income from mining, where the bag premium did not exceed the cost of the bags plus the cost of packing and loading the cement in bags.

3. Whether the cost of loading bulk cement onto rail cars, barges, or trucks and the cost of owning and operating distribution terminals should be excluded in applying the proportionate profits method to determine General Portland's gross income from mining.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Petitioner, General Portland Cement Company ("General Portland"), respectfully prays that a writ of certiorari issue to review, in part, the decision of the United States Court of Appeals for the Fifth Circuit entered on October 10, 1980, affirming in part, reversing in part and remanding in part a judgment of the United States District Court for the Northern District of Texas.

## OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit is reported at 628 F.2d 321, and is set forth as Appendix B, *infra* pp. 1b-51b. The decision of the United States District Court for the Northern District of Texas,

Dallas Division, reported at 438 F. Supp. 27, is set forth as Appendix A, *infra* pp. 1a-25a.

## JURISDICTION

The opinion of the Court of Appeals for the Fifth Circuit was filed on October 10, 1980. This petition for certiorari was filed within ninety (90) days of that date. The jurisdiction of the Court is invoked under 28 U.S.C. §1254(1).

## QUESTIONS PRESENTED

1. Whether, in applying the proportionate profits method to determine gross income from mining under section 613(c) of the Internal Revenue Code of 1954, 26 U.S.C.[1], General Portland's first marketable product is bulk cement and does not include cement sold in bags.

2. Whether the additional charge for cement sold in bags (the "bag premium"), the cost of the bags and the cost of packing and loading the bags should be excluded in applying the proportionate profits method to determine General Portland's gross income from mining, where the bag premium did not exceed the cost of the bags plus the cost of packing and loading the cement in bags.

3. Whether the cost of loading bulk cement onto rail cars, barges, or trucks and the cost of owning and operating distribution terminals should be excluded in applying the proportionate profits method to determine General Portland's gross income from mining.

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[1]Unless otherwise indicated all statutory references are to the Internal Revenue Code of 1954, 26 U.S.C.

## STATUTE AND REGULATIONS INVOLVED

§613. *Percentage Depletion*

(a) GENERAL RULE. — In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion).

* * * * * *

(c) DEFINITION OF GROSS INCOME FROM PROPERTY. — For purposes of this section —

(1) *Gross income from the property.* — The term "gross income from the property" means, in the case of a property other than an oil or gas well, the gross income from mining.

(2) *Mining.* — The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

* * * * * *

(4) *Treatment processes considered as mining.*

* * * * * *

(F) in the case of calcium carbonates and other minerals when used in making cement — all processes

(other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent processes;

* * * * * *

The applicable provisions of Treasury Regulations 118, § 39.23(m)-1 (1953) ("Regulations 118") and Treasury Regulations § 1.613-3 (1968) are set forth in the Appendix C, *infra* pp. 1c-9c.[2]

## STATEMENT

General Portland is an integrated miner-manufacturer of cement and cement products. In computing taxable income, General Portland is allowed to deduct an amount for depletion equal to a specified percentage of its gross income from mining. I.R.C. §§611 and 613. In the case of calcium carbonates and other minerals when used in making cement, the term "mining" includes "all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process." I.R.C. §613(c)(4)(F). Since General Portland did not sell kiln feed and no representative market or field price existed for kiln feed, it is necessary to determine General Portland's gross income from mining under some other method.

This case involves the taxable years ended December 31, 1960 through December 31, 1968. For all years in issue, the applicable treasury regulations provided that where the taxpayer did not sell the product of mining and no representative market or field price existed for such product, the taxpayer should determine its gross income from mining under what is called the "proportionate profits method."

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[2] On March 15, 1972, Treas. Reg. §1.613-4 (1972) was adopted to replace Treas. Reg. § 1.613-3. *See* 37 Fed. Reg. 5373 (1972) [T. D. 7170, 1972-1 C. B. 178].

Regulations 118, §39.23(m)-1 was in effect through the end of the taxable year 1967. *See* Appendix C, *infra* pp. 1c-2c. On July 26, 1968, the Internal Revenue Service issued Treasury Regulations §1.613-3, which also provided for computation of the taxpayer's gross income from mining under the proportionate profits method but greatly expanded the scope of the regulations. 33 Fed. Reg. 10692 (1968) [T.D. 6965, 1968-2 C.B. 265]; *see* Appendix C, *infra* pp. 2c-9c.

Each of the issues considered by the district court and the Fifth Circuit in this case concerned the computation of General Portland's percentage depletion deduction.[3] This petition for writ of certiorari concerns the proper application of the proportionate profits method to determine General Portland's gross income from mining.

The proportionate profits method can be stated by the following formula:

$$\frac{\text{Mining costs}}{\text{total costs (mining + nonmining)}} \times \text{gross sales} = \text{gross income from mining}$$

In the proportionate profits formula, as stated above, the gross sales figure is the gross sales of the taxpayer's "first marketable product." Thus, the underlying assumption of the proportionate profits method is that each dollar of cost produces a proportionate dollar of profit upon the

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[3] The issues considered by the courts below, in addition to the issues stated above, were: (1) whether discounts for prompt payment offered by General Portland were "cash" discounts or "trade" discounts, and (2) whether interest income could offset interest expense in applying the "50% limit" on percentage depletion provided under section 613(a). These issues are not discussed in this petition, but if this Court should grant certiorari herein, the Court should also review the Fifth Circuit's conclusion that the discounts offered by General Portland were "trade" discounts.

sale of the taxpayer's first marketable product. *See Standard Lime and Cement Co.* v. *United States,* 329 F.2d 939, 944 (Ct. Cl. 1964).

General Portland, during the years in issue, sold cement both in bulk and in bags. Between 10% and 20% of General Portland's sales were attributable to the sale of cement in bags. The Fifth Circuit held that cement in bulk and in bags constituted General Portland's "first marketable product." Therefore, in applying the proportionate profits formula, the Fifth Circuit held that General Portland's gross sales included the total proceeds of sale of cement in bulk and in bags. The conclusion that General Portland's first marketable product was cement in bulk and in bags is in direct conflict with the Tenth Circuit's decisions in *United States* v. *Ideal Basic Industries, Inc.,* 404 F.2d 122 (1968), cert. denied, 395 U.S. 936, rehearing denied, 396 U.S. 975 (1969); and *Portland Cement Co. of Utah* v. *Commissioner,* 614 F.2d 724 (1980), cert. granted October 6, 1980 (hereinafter referred to as "Utah Portland").

General Portland charged an additional amount for cement sold in bags, called a "bag premium," and incurred additional costs of packing and loading cement in bags. The parties stipulated that, during the years in issue, the amount of the bag premium charged by General Portland did not exceed the cost of bags plus the additional costs incurred in packing and loading the cement in bags. Despite the fact that the bag premium, at most, merely offset the costs incurred in packing and loading cement in bags, both the district court and the Fifth Circuit held that the bag premium and the costs of packing and loading the cement in bags should be included in the proportionate profits formula. Such holding is in direct conflict with the assumption underlying the proportionate profits method and the Tenth Circuit's decisions in *Ideal Basic* and *Utah Portland.*

General Portland also incurred costs in packing and loading bulk cement and in operating distribution terminals for the distribution of bulk and bagged cement. Since General Portland's first marketable product was bulk cement and all processes for the production of cement had been completed before General Portland incurred the bulk loading and the distribution costs in question, General Portland contends that such costs should be excluded in applying the proportionate profits method in accordance with the Tenth Circuit's decision in *Ideal Basic*. In the alternative, General Portland contends that if such costs are included in the proportionate profits formula, such distribution costs are attributable to both its mining and nonmining activities and should be allocated between mining and nonmining costs. Both the district court and the Fifth Circuit held, however, that the distribution costs in issue were includible in the proportionate profits formula as nonmining costs.

In *Ideal Basic* the Tenth Circuit considered the proper treatment of the bag premium, cost of bagging, cost of loading bulk cement and the cost of operating distribution terminals in the context of the proportionate profits method. The Tenth Circuit held that the bag premium, cost of bagging, cost of loading bulk cement and cost of operating distribution terminals should be excluded in applying the proportionate profits method under Regulations 118, § 39.23(m)-1. The Third Circuit in *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F.2d 468 (1966) reached the opposite result with respect to the bag premium and the cost of bagging and loading cement. In *United States* v. *California Portland Cement Co.*, 413 F.2d 161 (1969), the Ninth Circuit applied Treasury Regulations § 1.613-3 retroactively and held that the bag premium and bagging costs should not be excluded in applying the proportionate profits method.

## REASONS FOR GRANTING THE WRIT

### CERTIORARI SHOULD BE GRANTED IN THIS CASE TO RESOLVE THE CONFLICT BETWEEN THE FIFTH CIRCUIT'S DECISION IN THIS CASE AND THE TENTH CIRCUIT'S DECISIONS IN IDEAL BASIC AND UTAH PORTLAND.

In *Ideal Basic,* the Tenth Circuit held that the bag premium, bagging costs, bulk loading costs and distribution costs, basically identical to the costs involved in this case, should be excluded from the proportionate profits formula under Regulations 118, § 39.23(m)-1, for taxable years prior to 1968. In *Whitehall,* the Third Circuit held that the bag premium and bagging costs should not be excluded from the proportionate profits formula under Regulations 118, § 39.23(m)-1. In *California Portland,* the Ninth Circuit held that the bag premium and bagging costs should not be excluded from the proportionate profits formula for years prior to 1968, relying upon the retroactive application of Treasury Regulations § 1.613-3. In *Utah Portland,* the Tenth Circuit recently reaffirmed its decision in *Ideal Basic* and held that the bag premium, bagging costs and other distribution costs should be excluded from the proportionate profits formula for years after 1968.

In this case, the Fifth Circuit ruled that the bag premium, bagging costs, loading costs and distribution costs must be included in applying the proportionate profits formula both for periods before and after the date of issuance of Treasury Regulations §1.613-3. Therefore, a clear conflict exists between the Fifth Circuit's decision in this case and the Tenth Circuit's decisions in *Ideal Basic* and *Utah Portland.*

## THIS COURT'S FINAL DISPOSITION OF THE *UTAH PORTLAND* CASE MAY DETERMINE THE NEED FOR CERTIORARI IN THE INSTANT CASE.

On October 6, 1980, this Court granted certiorari, upon the Government's application, in *Commissioner of Internal Revenue v. Portland Cement Company of Utah*, No. 79-1907, on certiorari from the United States Court of Appeals for the Tenth Circuit. The issues involved in *Utah Portland*, with respect to the bag premium, bagging costs, loading costs and distribution costs, are identical to those issues presented in this case. The taxable years in issue in *Utah Portland* are 1970 through 1972, and the taxable years involved in this case are 1960 through 1968. Thus, the only difference between the issues presented in this case and the issues presented in *Utah Portland* are (1) for the years 1960 through 1967, the regulations in force and effect were Regulations 118, §39.23(m)-1, and this case involves the proper interpretation and application of such regulations; and (2) while the Fifth Circuit did not rely upon the retroactive application of Treasury Regulations §1.613-3, this case also concerns the possible retroactive application of such regulations to years prior to 1968. For the year 1968, the Fifth Circuit relied upon Treasury Regulations §1.613-3 in holding that bag premiums, bagging costs, bulk loading costs and distribution costs could not be excluded in applying the proportionate profits method, and the Tenth Circuit in *Utah Portland* clearly rejected the application of such regulations to the years 1970 through 1972.

If this Court should affirm the *Utah Portland* decision from the Tenth Circuit, a further reason for granting the writ of certiorari would then exist because the decision below would conflict with this Court's decision in *Utah Portland*. A grant of the writ of certiorari and remand of this case to the Fifth Circuit for proceedings consistent with

this Court's opinion in *Utah Portland* would then be appropriate. Moreover, in the event the *Utah Portland* case does not fully resolve the stated issues with respect to application of the proportionate profits method, this case presents an excellent alternative vehicle for clarification of that question.

## CONCLUSION

This petition for a writ of certiorari should be held until the decision in *Utah Portland* is finalized, at which time it should be determined if certiorari is to be granted and if this case should be heard by this Court or remanded to the United States Court of Appeals for the Fifth Circuit.

Respectfully submitted,

BUFORD P. BERRY

EMILY A. PARKER

2300 Republic National Bank
Building
Dallas, Texas 75201

*Counsel for Petitioner*

Date: January 6, 1981

# APPENDIX

## APPENDIX A

# United States District Court

NORTHERN DISTRICT OF TEXAS,
DALLAS DIVISION

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GENERAL PORTLAND CEMENT COMPANY,
*Plaintiff,*

v.

UNITED STATES OF AMERICA,
*Defendant.*

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CIVIL ACTION No. 3-5212-F.
FILED MAY 17, 1977.

BUFORD P. BERRY and
EMILY A. PARKER
Dallas, Texas
*for the Plaintiff.*

EUGENE G. SAYRE
Tax Division, Department
of Justice, Dallas,
Texas, WILLIAM W. GUILD,
Attorney-in-Charge
*for the Defendant.*

## MEMORANDUM OF DECISION

### I. NATURE OF CONTROVERSY

ROBERT W. PORTER, District Judge.

Plaintiff, General Portland Cement Company (the name of which has been changed to General Portland, Inc.), complains that the United States (hereinafter referred to as the IRS or Service) erroneously assessed and collected $2,178,046.42 for the taxable years beginning December 31,

1960, through and including December 31, 1968.[1] Plaintiff urges an increase in the amount it has been allowed to take as a depletion deduction arguing that specific costs and income are properly attributable to plaintiff's mining operation. Finding both jurisdiction and venue proper in this case, trial was held, without jury, beginning May 14, 1975. After full consideration of all facts, argument, briefs, and for the following reasons it is decided that:

1. The "bag premium" (increased price on the sale of bagged cement) is an increase in the sales price of cement sold and may not be set-off against "bag costs".

2. The cost of bags and the cost of packing and loading cement is a direct manufacturing expense;

3. The cost of owning and operating terminal facilities is a direct manufacturing expense;

4. The discount which was granted by General Portland to its customers is a cash discount and therefore does not reduce the price of the cement which was sold but rather is a financial expense which is allocable; and

---

[1]

| Taxable Year Ended | Income Tax | Interest | Total |
|---|---|---|---|
| December 31, 1960 | $149,637.97 | $ —0— | $149,637.97 |
| December 31, 1961 | 148,939.82 | 37,596.07 | 186,535.89 |
| December 31, 1962 | 131,993.24 | 31,018.17 | 163,011.41 |
| December 31, 1963 | 142,578.10 | 24,951.12 | 167,529.22 |
| December 31, 1964 | 229,494.64 | 100,140.62 | 329,635.26 |
| December 31, 1965 | 278,523.55 | 104,656.44 | 383,179.99 |
| December 31, 1966 | 254,661.78 | 80,778.09 | 335,439.87 |
| December 31, 1967 | 96,631.31 | 25,277.90 | 121,909.21 |
| December 31, 1968 | 283,249.99 | 55,917.61 | 341,167.60 |

(See Strip, P.5 filed May 9, 1973)

5. The interest expense of borrowed funds can be netted with interest income and included in allocable administration overhead.

The conceptual question posed in this decision is whether this Court will characterize certain costs as direct mining costs, direct manufacturing costs, indirect expenses, or costs related neither to mining nor manufacturing. It will also be necessary to decide either to include or exclude certain income items from the total dollar amount of gross sales derived from cement. To analyze those questions the proper factual and legal framework must first be developed. Therefore I begin in Section II by outlining the method by which cement is manufactured and marketed as well as by describing the underlying economic condition of the cement industry generally and General Portland in particular. In Section III, I develop a legal framework for the proportionate profits method and analyze the actual dynamics of the arguments presented to the court. That is, I demonstrate the "moving force of" each argument in general terms using simple arithmetic computations as examples. Section IV presents a detailed analysis of each cost or item of income and an application of the correct rule of law to the specific issues in dispute. Finally, Section V contains a summary of the Court's conclusions as well as an order to prepare judgment.

## II. BACKGROUND

### *A. The Making of Cement.*

General Portland is an integrated mining and manufacturing company which produces cement and cement products. During the years at issue in this suit, Plaintiff mined limestone, clay and shale[2] and processed those raw

[2] For the years in question the applicable percentage depletion rates were 15% for limestone, and clay and 15% for shale. (Strip. P.10)

materials into finished cement at nine locations in the United States. The plants were divided among five divisions, and the department leader at each division reported directly to each of his superiors at corporate headquarters.

The manufacture of cement begins with limestone, shale, or clay which is first mined at a quarry and then transported to a primary crusher which reduces the size of the ore. That crushed ore is stockpiled near the processing plant along with other necessary minerals which are either purchased or extracted from Plaintiff's quarries. Water is added and the minerals are further ground, creating a mixture which has the appearance of mud and is called "slurry." Slurry is then pumped into large slurry-blending, and storage tanks where it is agitated continually to keep the solids from settling and to keep the mixture homogeneous. From the slurry-blending tanks, the slurry is then pumped into a rotary kiln where it is heated. A series of chemical reactions take place as the slurry is transformed by the heat into which is termed a "cement clinker". The cement clinker is cooled and later the clinker, along with gypsum, is ground into finished cement which is transported to storage silos at the plant or at distribution terminals. There is no dispute between the parties with regard to the actual methods of manufacturing used by the Plaintiff.

*B. The Marketing of Cement.*

Plaintiff sells the cement which it produces either in bulk or in paper bags. Cement in bulk is loaded directly from a storage silo into a rail car, barge, or truck for shipment. Upon receiving an order for bagged cement, the finished cement is transported from the storage silo to a bagging machine. There is no chemical or practical difference between the cement loaded from the storage silo to a truck or a barge and that loaded into a bag. Plaintiff did not keep

an inventory of packaged cement but rather filled bags only when actual orders were received. From ten to twenty percent of Plaintiff's gross sales were attributable to the sale of cement in bags during the years 1961 through 1968. A higher price was charged by Plaintiff for cement sold in bags as compared to cement sold in bulk; that additional price is termed a "bag premium" by the industry.

The amount of the bag premium during each of the years in question was approximately ten to fifteen cents per bag.[3] It is Plaintiff's contention that it intended to recoup, if possible, the additional cost incurred in bagging cement and that the bag premium was not an increase in the price of cement. In support of that contention Plaintiff elicited testimony that its corporate headquarters, which set the amount of the bag premium, collected information from the division accounting departments concerning the cost of bags, and from the plant operations departments concerning the cost of packing and loading the bags, in order to determine the additional costs incurred in bagging the cement and by that process established the amount of the bag premium. It is further argued that the bag premium charged by the Plaintiff did not exceed the cost of the bags plus the additional costs incurred in packing and loading the cement in bags.

During each of the years in issue, Plaintiff offered a cash discount to its customers for prompt payment. The amount of the discount through November 1, 1961 was ten cents per barrel for white cement. From about November 1, 1961,

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[3]

| Year | Amount of the Bag Premium | Year | Amount of the Bag Premium |
|---|---|---|---|
| 1960 | $1,787,144.99 | 1964 | 1,980,093.28 |
| 1961 | 1,823,833.00 | 1965 | 2,014,359.28 |
| 1962 | 1,746,473.87 | 1966 | 2,022,488.11 |
| 1963 | 2,000,105.07 | 1967 | 1,938,161.07 |
| | | 1968 | 2,340,487.48 |

and through December 31, 1968, the discount was twenty cents per barrel for gray cement and forty cents per barrel for white cement. The basic terms of the discount through January 1, 1964 were:

> Discount if payment made within fifteen days from the date of invoice, full payment due within thirty days of invoice.

From January 1, 1964 through December 31, 1968 the basic terms of the discount were:

> Discount allowed if payment made by the 10th of the month for shipment invoiced during the previous month, full payment due by the last day of the month following the month of shipment.

Similar cash discounts had been offered by the Plaintiff since at least 1948. Most other competing cement manufacturers also offered what they termed a "prompt payment discount" with terms similar to those offered by the Plaintiff. As the industry discount would rise or fall, Plaintiff would meet those changes.

Plaintiff advised all of its customers of the terms of its discount through trade quotations, specific work contracts, and sales invoices. The sales invoices which were transmitted to the customer for payment reflected the total invoice price, without reduction for the discount, and a separate statement contained the discount amount. Plaintiff did not charge its customers anything denominated interest on accounts paid beyond the date specified in the invoice. If the account remained unpaid for more than ninety days, the Plaintiff would generally attempt to obtain a promissory note from the customer in the amount owing on the account and bearing interest at four to five percent per annum.

Between 1961 and 1968, ninety to ninety-five percent of Plaintiff's customers took advantage of the discount offered to them. Approximately eighty to eighty-five percent of those who did not take advantage of the discount complied with Plaintiff's terms by transmitting the total price to Plaintiff after the expiration of the discount period. The remainder of the customers who did not earn the discount offered by Plaintiff attempted to take advantage of the discount without complying with the discount terms, by transmitting the next payment to the Plaintiff after expiration of the discount period. In those situations the Plaintiff, disallowed for the most part, the discount claimed by the customer and rebilled the customer.[4]

Since 1950, Plaintiff has allowed the division sales manager to determine whether a discount should be disallowed if the net payment was received within three days from the end of the discount period. The three day grace period was initiated in response to tardy postal service. On occasion the division sales manager disallowed discounts taken by customers where the payment was received within the three day grace period and the customer was habitually late in payment. The division sales manager did not have the authority to allow a discount where the net payment was received more than three days after the end of the discount period. A discount taken after that period could be allowed only upon approval by corporate headquarters. If the division accounting office received a payment more than three days after the end of the discount period when the discount had been taken, the division sales manager could disallow the discount taken, or, if he felt it should be allowed because of extenuating circumstances, he transmitted the invoice and related materials to Plaintiff's cor-

[4] The total amount in dollar value disallowed from 1960 through 1967 is $1,300,000.

porate headquarters for consideration of whether to grant the allowance.

After the corporate headquarters had determined whether the discount should be allowed the division accounting office took the appropriate action to either rebill the unearned discount or credit the customer's account for the discount which was allowed. The division accounting office rebilled those disallowed discounts by sending the customer a letter advising him that he had not complied with the payment terms necessary to earn the discount and, therefore, he would be required to pay the gross amount of the original invoice. Plaintiff also required each division accounting department to submit monthly reports regarding cash discounts to its corporate office headquarters. Annual statistics compiled from those reports reveal that Plaintiff collected approximately 90% to 93% of all of its invoices for the years 1960 through 1967 within the discount period, which included the three-day grace period for mailing.[5]

*C. The Business of Cement.*

The Plaintiff was required to invest heavily in automated and semi-automated equipment to manufacture cement. Hence the fixed costs of producing cement is and was high in comparison to those costs which are variable such as the cement ingredients. The profit maximizing manufacture with such a debt structure will attempt to increase production to capacity so that all fixed cost assets are contributing as much as they profitably can. Testimony revealed that the average cement producer must invest approx-

[5] A compilation of the monthly reports was not prepared for 1968 because the company adopted a more decentralized corporate structure in 1967 after moving its corporate headquarters to Dallas, Texas from Chicago, Illinois. Hence it was not possible to generate statistical information.

imately one dollar of capital for each thirty-three cents of annual sales. Since cement produced by one company is all but identical to the cement produced by others, there can be competition only among products in terms of price and services.

Throughout the decade of the fifties the cement industry enjoyed high demand and expanding capacity. That demand was attributable in large part to the relatively quick-paced growth of the construction industry and in particular to the growth of highway construction. During the early sixties industry conditions changed and capacity utilization dropped from a high of 95% in 1955 to 74% in 1960 and remained at about that rate throughout the sixties. Prices dropped from $3.37 per barrel in 1960 to $3.15 per barrel in 1966.

The trends of the industry were characteristic of General Portland. Net sales increased from approximately $40 million in 1955 to $67 million in 1959, an increase of 67%, but dropped below the 1959 level through 1965 and only increased to $74 million in 1967. Throughout the sixties General Portland enjoyed a relatively liquid financial structure. The company's ratio of assets to liabilities was never below 2.5, and for a majority of the years in question was in excess of 3. well above the national average of 2. General Portland's strong financial posture is also reflected in the relatively low ratio of long-term debt to equity which was never greater than 13.6%. In 1965, General Portland arranged a two-year $15 million revolving credit at the prime commercial rate. That arrangement was extended in 1967 even though the Plaintiff was not drawing on those funds.

## III. THE PROPORTIONATE PROFITS METHOD

[1] Depletion is designed to recompense the taxpayer for the exhaustion of his mineral assets. See *United States*

*v. Cannelton Sewer Pipe,* 364 U.S. 76, 80 S.Ct. 1581, 4 L.Ed.2d 1581 (1960). In the present case, the taxpayer has computed the amount of its allowable depletion as a specific percentage of the annual gross income from the property mined. At no time can the percentage depletion, so computed, exceed fifty percent of taxable income from the property mined. *IRC* § 613(a). If Plaintiff were simply a mining operation and sold its ore to the highest bidder in the open market there would be no difficulty determining the gross income earned from the sale of the "mined property". But the taxpayer is an integrated miner-manufacturer and there is, in fact, no sale of the mined ore to the manufacturing stage of its operation. Therein lies the problem of this case. How is one to determine the income from something which is not actually sold?

The Service and the Courts have allowed a percentage of the gross sales of the first salable product to be allocated to the mining operations in the same proportion that mining costs bear to the total costs of the entire mining and manufacturing operation. Certain expenses, such as administrative overhead, are not directly attributable to either mining or manufacturing but benefit the entire operation and hence may be allocated between the mining and manufacturing operations in the same ratio as direct mining and manufacturing costs bear one to the other. Separate income, such as that from a separate economic enterprise, are not allocated between mining and manufacturing because the costs of that separate economic entity bear no relationship to the income of the property mined. If costs are not in fact "producing" costs or they do not benefit the entire operation, then they would distort the proportional relationship and reflect higher costs and hence more income which ultimately could be used to justify a higher depletion deduction. One can express the propor-

tionate profits method for determining the income attributable to mining by the following equation:

$$\frac{\text{Mining costs}}{\text{Total allocable costs}} \times \text{Gross Sales} = \text{Gross Income from mining}$$

Of course mining costs consist of direct mining costs, all costs which are incurred prior to actually feeding the slurry into the kiln, and all indirect costs, such as administrative and sales costs, which benefit the entire operation. Gross sales consist of the price for the cement multiplied by the quantity of sales. Thus a more articulated form the equation would read:

$$\frac{\text{Direct and Indirect mining costs}}{\text{(Direct and indirect mining costs plus Direct and indirect manufacturing costs)}} \times (PXQ) = \text{Gross Income From Mining}$$

To increase the gross income from mining and therefore the amount of the depletion deduction one would expect the taxpayer to argue for the highest price and quantity possible, for other income from related enterprises to be included in the gross sales figure, and for more costs to be allocated as indirect mining costs. The government would no doubt argue the converse so as to lower the amount characterized as gross income from mining. With this factual and legal predicate established I now turn to the specific issues of this case.

## IV. THE SPECIFIC ITEMS IN DISPUTE

In this case five distinct arguments are made concerning the characterization of certain costs and income. There is one alternative issue which is urged but because of the outcome of my decision on the primary issues it does

not need to be decided today. The primary issues for decision are:

1. Whether the additional charge made by Plaintiff to its customers when it sold cement in paper bags (known as a "bag premium") should be deducted from the sales price in computing Plaintiff's gross sales and offset against bag costs and related packing and loading costs in the computation of gross income from mining under the proportionate profits method;

2. (a) Whether the cost of bags and the cost of packing and loading cement are indirect expenses allocable to both the mining and manufacturing operations of Plaintiff in computing gross income from mining under the proportionate profits method or in the alternative;

(b) Whether the cost of bags and the cost of loading and packing cement incurred by Plaintiff should be excluded in computing gross income from mining under the proportionate profits method;

3. (a) Whether the expenses incurred by Plaintiff in owning and operating terminal facilities for selling cement are indirect expenses allocable to both the mining and manufacturing operations of Plaintiff in computing gross income from mining under the proportionate profits method; *or* in the alternative;

(b) Whether the expenses incurred by Plaintiff in owning and operating terminal facilities for selling cement should be excluded in computing gross income from mining under the proportionate profits method;

4. Whether interest expenses should be reduced by the amount of interest income to the extent of interest expense, to determine the amount of administrative

expense to be used in computing gross income from mining under the proportionate profits method;

5. Whether the discounts offered by the Plaintiff to its customers during each of the years in issue are "cash" discounts and not "trade" discounts for the purposes of computing depletion under the proportionate profits method.

Each is discussed in turn below.

*A. Bag Premium, Bag and Terminal Cost Issues.*

[2] The Plaintiff urges in its first three issues that the "bag premium" should be set-off against the costs of bagging cement and that the remaining bagging costs and also terminal distribution costs should be allocated as indirect costs in the same proportion as the direct mining (pre-kiln) costs bear one to the other. In support of those assertions Plaintiff argues two propositions: (i) that the "price" of cement should and is set by the first marketable product which is bulk and not bagged cement and (ii) that the actual producing or manufacturing stage of cement ends at the plant storage silo and that costs incurred in distribution are either indirect costs, attributable to both mining and manufacturing, or excludable non-mining, non-manufacturing costs.

Throughout the period of time relevant to this decision, the regulations in force have required that gross sales be derived from the first marketable product.[6] The Service

[6] Since 1940 the tax regulations have provided that the taxpayer's depletable gross income from mining must be computed under the "proportionate profits method", if no representative market price exists for the taxpayer's production from mining. Regulation 103, Section 19.-23(m)–1(F) (1940); Regulation III, Section 29-23(m)–1 (1943); Regulation 118, Section 39.-23(m)–1(E)(3) (1953); Treas.Reg.Sec. 1.613–3(d) (1954); Treas.Reg.Sec. 1.613–4(d) (1972). The taxpayer asserts that Regulation 118, Section 39.23(m)–1(E)(3) was in force and provides:

argues that Treasury Regulation § 1.613, the most recent regulation which was instituted in 1968 dealing with the apportionment of costs and the derivation of gross income, should be applied retroactively. If applied retroactively that regulation would characterize the "bag premium" as a sales price and the costs of bagging and satellite-non-plant-site terminal facilities as direct manufacturing costs. Because I independently reach an identical characterization under the old regulations I need not and do not make any decision on the retroactive application of Treasury Regulation § 1.613.

The Plaintiff, of course, urges this court to exclude the costs of bagging and the costs of the satellite terminal facilities or in the alternative to include them as indirect distribution or sales expenses: costs apart from processing or manufacturing costs. The complexity of the Plaintiff's argument are not to be underestimated; in an interrelated set of propositions Plaintiff attempts to create both the mood and the proper logical foundation for its conclusion. The first step in Plaintiff's argument involves the "bag premium" or extra price charged for bagged cement. One would of course expect that the Government would be seeking to reduce the price or to exclude the bag premium so as to reduce gross income from sales which is the multiplicand in the proportionate profits method formula. Nevertheless, in this case the Plaintiff is arguing for the exclusion of the bag premium. Why? Because the "bag premium" when set-off against the "bag costs", which logically must be excluded if the "bag premium" is excluded, would result in the elimination of a cost which would increase the denominator of

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. . . then there shall be used in lieu thereof the representative market or field price of the *first marketable product resulting from any process or processes* . . . minus the costs and proportionate profits attributable to the transportation (other than transportation treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes. (emphasis supplied)

the proportionate profits formula and decrease, by a multiple, the gross income. Thus, the issues of the cost of bagging and the bagging premium are hopelessly intertwined and are therefore considered together below. The satellite terminal issue is also considered in this section because that issue, like the bag cost and premium issues, becomes whether distribution costs are to be included in the manufacturing costs; are to be considered indirect costs; or are to be excluded altogether as non-mining and non-manufacturing costs.

Plaintiff first argues to exclude the bag premium reasoning that that cost is not the price of the first marketable product. The regulations provide that the price variable, in the proportionate profits formula, is to be derived from the price of the first marketable product. Two contentions are submitted by the Plaintiff in support of its position on the bag premium issue. First, it is urged that case law is dispositive of the "fact" that bagged cement is the first marketable product; and second, that Plaintiff's business practice as well as various policy considerations support the proposition that bagged cement should be treated as the first marketable product. Plaintiff's first argument is easily dismissed; it is impossible for a fact in this case to be established by those facts established in either of the cases cited by the Plaintiff.[7] The bag premium in this case is a portion of the price of the first marketable product and is simply another means to package and sell cement. In my view, there is no difference between the costs and therefore the price associated with loading bulk cement in a truck or a barge and loading that same cement in a smaller container (a bag) for the convenience of the taxpayer's customers. To say that the cement in the truck

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[7] *Standard Lime & Cement Co. v. U. S.*, 329 F.2d 939, 165 Ct.Cl. 180, (1964) and *United States v. Ideal Basic Industries Inc.*, 404 F.2d 122 (10th Cir. 1968) are the two cases cited by the Plaintiff.

and barge is the first marketable product is to defy the reality of the marketing process. Both large and small orders are sold as cement; the only difference between the two methods of sale is how the customer receives his cement. Different legal results which depend upon the mere size of the order of cement are simply not rational. Thus the "bag premium" is to be included in the price figure for cement and is not to be set off against bag costs.

As a correlative holding I must conclude that the costs generated in bagging cement are direct costs of manufacturing. There is no clear line which marks the difference between the costs of manufacturing and distribution. In *Standard Lime* the Court derived what I consider to be an overly rigid test based upon the expert testimony of taxpayer's expert that distribution costs are not considered direct processing costs. *Standard Lime & Cement Co. v. U.S.*, 329 F.2d 939, 948 at n. 21, 165 Ct.Cl. 180 (1964). The Plaintiff attempts to bolster the conclusionary analysis of *Std. Lime* with a two step rationalization. First it is argued that distribution costs are an inherent cost associated with the entire cement operation and that as such those costs should be allocated to both non-mining and mining functions of the plant operation. Second it is argued that if Plaintiff wished to sell the mined kiln feed it would be necessary for it to incur distribution costs and that at least a portion of those distribution costs finally incurred in the retail sale of cement are nothing more than costs which have been delayed until the finished product is manufactured. Therefore it is reasoned that the costs of bags and terminal facilities are indirect expenses which should be allocated between mining and non-mining in the same proportion as direct mining costs bear to the total costs of the operation.

In *Whitehall Cement Manufacturing Co. v. U.S.*, 369 F.2d 468 (3rd Cir. 1966) the Court allocated bagging and packing

costs to the non-mining operations of the company. I agree with the analysis of that Court. It is clear that cement stored in a site, even if it is chemically finished cement, is not seen as a finished product by the consumer. It still must be portioned, stored, or packed in a form accessible to the retail market. That is to say, manufacturing and processing means completing the "finished" product and making it salable. Certainly the taxpayer does not intend that the costs associated with loading cement into the storage silos on the plant site are not manufacturing costs. They are packing costs; the taxpayer is readying the cement to be loaded into the truck or barge. How can readying the cement to be purchased in smaller quantities be considered anything but a completion of the manufacturing process? I therefore conclude that bagging costs are necessary to finish the non-mining process and should be included in the direct costs associated with as mining.

**[3-5]** For the above reasons, I also find that the costs of the satellite terminals are direct, non-mining expenses. They too are simply packaging devices which from the consumers viewpoint, simply make the bulk cement accessible. The satellite terminal is the means by which the taxpayer "packages" his product and hence should be included in the non-mining cost. Processing in marketing terms and as that term is used in Regulations means the process of dividing the raw cement into a marketable quantity. See *IRC* 613(c)(4). I cannot conclude, as the Plaintiff vigorously urges, that "process" means only "chemical processing". The proportionate profits method was developed to distribute costs over the entire range of mining and non-mining activities. To say that satellite terminals are "sales" devices which benefit the entire operation or alternatively that they are distribution facilities which are so removed from mining and manufacturing that they should not be included is to overlook the fact that the consumer only

purchases the portioned bulk cement and does not purchase just the bulk cement that is produced by the Plaintiff. Congress must have meant, then, that processing costs includes more than cooking the meal; serving it in portions which are easily handled, which are attractive, and which are accessible to the dinner is when the process of preparing a meal is completed: So too the processing of cement.

*B. Interest Expense.*

**[6, 7]** For the years 1960 through 1964, Plaintiff had interest income primarily from short-term investments in Treasury bills and commercial paper. During that same period, Plaintiff incurred interest expense, which was primarily attributable to interest on $15 million in debentures issued by Plaintiff in 1957. Plaintiff asserts that the earned interest income on the borrowed funds should be reduced by the interest income on that same money to determine the actual "cost" of holding the funds which the taxpayer characterizes as administrative expenses. Plaintiff does not contend that it is entitled to include the interest income in the computation of its gross-income from mining. The sole issues for determination here are (i) whether administrative expenses include interest costs on funds which are used to benefit the entire operation and (ii) whether those expenses may be reduced by interest received on those borrowed funds.

While there is testimony that large capital commitments were made to new manufacturing facilities during the time period that Plaintiff borrowed the funds, there is also testimony that the monies were also used by Plaintiff to improve the operation of the Plaintiff's mining operations. Hence, after full consideration of the record and with the understanding that all of the money which was held as debt is tangible and cannot be traced specifically from the loan

to either mining or manufacturing, I find that the interest costs were properly included in administrative overhead. Thus the only question remaining is whether the interest income earned on the borrowed funds may be set-off against the interest income of those funds. The netting of interest income against interest expense does not change the proportionate profits fraction or Plaintiff's "gross income from mining". The depletion deduction is limited to fifty percent of Plaintiff's "taxable income from the property". *IRC* § 613(a). Since taxable income is gross income less expenses, reducing Plaintiff's interest expense by the amount of its interest income affects the determination of taxable income from the property and not the gross income figure. Thus, this issue concerns only the determination of Plaintiff's taxable income from "the property" for purposes of the fifty percent limitation and does not affect the determination of the Plaintiff's "gross income" from mining on which percentage depletion is computed.

The Plaintiff did not include or attempt to include its interest in its gross income in computing its gross income from mining. In compiling the fifty percent limitation upon the depletion deduction, however, the Plaintiff reduced its interest expense by the amount of its interest income. The taxpayer also reduced what I have characterized as the indirect cost of the funds by the income earned on those funds. The result of that computation would be to distribute less cost to both mining and non-mining activities. That distribution, however, is in the same proportion as direct mining costs bear to the sum of direct manufacturing and mining costs. In other words, the fraction which is then multiplied by the gross sales income remains the same whether this court increases or decreases the indirect administrative expenses.

In what can only be characterized as a peculiar decision, the tax court in *Island Creek Coal Co. v. Comm.*, 30

T.C. 370 (1958) refused to allow an integrated coal mining operator to reduce his direct mining costs by income derived from the sale of scrap mine supplies. In an amended answer the Service appears to have urged that the taxpayer should not net the costs and income of the salvaged mining supplies to determine the gross income from the property mined. It is peculiar in the first place that any costs were deducted from the "gross income" figure. Indeed gross income from the property mine means the *gross* or *all the* sales income from the sale of the mined property, the gross income is not reduced by the costs associated with mining. Moreover, it is peculiar that the taxpayer would argue for a reduction in his direct mining costs, a cost which is expressed as the numerator of the proportionate profits fraction and which if increased would increase the percentage income which could be attributed to mining and hence fall within the depletion deduction. *Island Creek,* if it has any precedential value, is strictly limited to its facts and perhaps the oblique trial strategy which dictated its queer result.

Two other decisions are cited by the Service for the proposition that administrative expenses cannot be reduced by interest income. Nevertheless in those two cases, *Guthrie v. United States,* 323 F.2d 142 (6th Cir. 1963) and *Whitehall Cement Co. v. United States,* 369 F.2d 468 (3rd Cir. 1966) the courts were clearly resolving a different issue: whether the gross income figure in the proportionate profits method could be increased by the inclusion of income which was earned from other sources besides mining. In *Guthrie* the taxpayer sought to include insurance proceeds from a "business interruption" policy. Damages under that policy were measured by the difference between the dollar value of coal which was sold and the dollar value of that which was estimated could not have been sold because of the business interruption. The Sixth Circuit correctly reasoned that the purpose of the depletion allowance would be sub-

tracted if a deduction were allowed for income which had no relation to a reduction of the capital stock, property mined, and that therefore income, even if generated from an insurance policy based upon what could have been mined, should be excluded. Similarly the court in *Whitehall Cement Co.* excluded from the gross sales figure, income from the resale of cement purchased from another. It was also held that gross income from the property mined meant just that: no extraneous income should be included within that variable because the depletion deduction should reflect the reduction of the taxpayer's capital stock. *See e.g. United States v. Cannelton Sewer Pipe Co.*, 364 U.S. 76, 80 S.Ct. 1581, 4 L.Ed.2d 1581 (1960).

The Plaintiff in this case, is not attempting to include more income in its gross sales income figure. The Plaintiff is attempting to reduce taxable income by reducing interest cost by interest earned and to decrease its total administrative cost by the same amount. I hold that the Plaintiff is justified and that interest expense may be set-off against interest income in determining the true administrative cost of the entire operation.

*C. The Discount.*

**[8, 9]** Finally, Plaintiff urges that discounts given between 1960 and 1968 are "cash" discounts and not "trade" discounts while the Service argues the reverse. As described by the Court in *Standard Lime:*

> Cash discounts are granted to purchasers in order to encourage prompt payment thus producing a quicker flow of working capital. They differ from trade discounts in that the latter are granted at the option of the seller no matter when payment is made, depending on market conditions, while the former are availed of entirely at the option of the purchaser. Thus trade

> discounts are deemed reductions in sales price and thus not includible in taxpayer's total gross income, while cash discounts are treated as a financial expense to the vendor and thus includible in taxpayer's gross income.

The determination of whether a particular discount is characterized as one of "trade" or "cash" is a question of fact. This Court must determine whether the taxpayer has proven by a preponderance of evidence that the discounts were intended to induce prompt payment rather than by a desire to encourage sales. The Service argues that in addition to being conditioned upon early payment, a true "cash" discount must also be substantially equivalent to the interest one would charge for the use of the net amount paid in advance for the period of time that the payment at its latest would be due. See Rev.Rul. 60-257, 1960-2 Cum. Bull. 197. After a review of the following facts, I find that the discounts offered by the Plaintiff are cash discounts and not trade discounts. In arriving at that conclusion I have divided my inquiry into two steps. First I analyze the actual policy and results of the Plaintiff's business to determine whether there was as condition precedent of prompt payment the granting of the discount and secondly I hold that the "interest equivalency" test even if applicable was applied improperly in this case.

Turning to my first determination I find on the basis of the credible facts that:

> 1. Plaintiff offered the discount to induce early cash payment;
>
> 2. The discount was effective in collecting ninety to ninety-five percent of the accounts receivable over the time period at issue in this case;

3. The Plaintiff strictly enforced the cash discount; and

4. Strict enforcement of the cash discount was achieved through close supervision of those personnel who were allowed to give discounts and by closely restricting those who could give the discounts.

Thus unlike the taxpayers in *Southwestern Portland Cement Co. v. United States,* 435 F.2d 504 (9th Cir. 1970) and *United States v. California Portland Cement Co.,* 413 F.2d 161 (9th Cir. 1969) the Plaintiff, in this case, has strictly enforced the discount provision and, for example, while the taxpayer in *California Portland* disallowed only about .035% of the discounts offered, the Plaintiff in this case has disallowed five to ten percent of the discounts which it offered to Plaintiff's customers. General Portland clearly allowed the discounts only on prompt payment.

The Service, however, argues that the discount, even though enforced, varied with the discounts offered by others in the industry and therefore must be viewed as simply a price reduction. The cement is described as a fungible product and it was noted that competition could only take place in price and *services.* Prompt payment or conversely the willingness to allow late payment could be looked upon as a service. To remain competitive the Plaintiff would be required to meet competition in that service. In all fairness there can be little doubt that price was also a factor on the part of the consumer's decision purchase.

The Service tacitly argues that if the Plaintiff did offer a service, that is loaning money for the longer payment period, then that loan must be equivalent to interest. The Service focuses the discount period which it presumes is the time over which the full payment is or will become due if the discounted payment is not made. There is absolutely

no evidence that that time period is the proper interval of time. Thus, for example, if payment is not made by the tenth of the month following the sale and the taxpayer is then required to make full payment by the end of the next month, the Service urges that the Court accept as the critical interest period the remaining twenty days in the first month plus thirty days in the next month, or fifty days. The unproven assumption in the Service's argument is that payment is finally made by the thirtieth day. The testimony is to the contrary. Often collection problems occur and collection was not made for some time after the full payment deadline. Thus without an accurate time interval the discount figures which were computed by the Service are baseless. From the taxpayer's point of view the opportunity cost of the discount is measured by the ultimate cost of foregoing the encouragement of prompt payment. Certainly the taxpayer could borrow in the short-run to cover accounts receivable but in the long-run it may be that the discount not only encourages prompt payment but more importantly encourages eventual payment. Collection costs as well as interest costs must be viewed as one. To apply a simpler more mechanistic test would belie reality and would make a farce out of the concept of opportunity cost. Hence, I conclude that the Plaintiff in this case intended the discount as a cash discount to encourage final payment. The interest equivalency test posited by the Service even if theoretically correct is not applied correctly in this case.

## V. SUMMARY

As provided in Section I, and for the reasons set forth above, I decide:

1. The "bag premium" (increased price on the sale of cement) is an increase in the sales price of cement sold and may not be set-off against "bag costs".

2. The cost of bags and the cost of packing and loading cement is a direct manufacturing expense;

3. The cost of owning and operating terminal facilities is a direct manufacturing expense;

4. The discount which was granted by General Portland to its customers is a cash discount and therefore does not reduce the price of the cement which was sold but rather is a financial expense which is allocable; and

5. The interest expense of borrowed funds can be netted with interest income and included in allocable administration overhead.

The parties to this case are ordered to prepare a judgment which is to be consistent with this opinion within 40 days from entry of this decision.

**APPENDIX B**

# United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 77-2831

GENERAL PORTLAND CEMENT COMPANY,
*Plaintiff-Appellee*
*Cross-Appellant,*

v.

UNITED STATES OF AMERICA,
*Defendant-Appellant*
*Cross-Appellee.*

APPEAL FROM THE DECISION OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF TEXAS

Argued
Before GOLDBERG, FAY and ANDERSON,
*Circuit Judges*

M. CARR FERGUSON,
Assistant Attorney General
GILBERT E. ANDREWS
GRANT W. WIPRUD
FRANCIS J. BLANCHFIELD, JR.
Attorneys, Tax Division
Department of Justice
Washington, D.C. 20530
*Attorneys for Defendant-Appellant*
*Cross-Appellee*

BUFORD P. BERRY, ESQUIRE
EMILY A. PARKER, ATTORNEY
2300 Republic National Bank Building
Dallas, Texas 75201
*Attorneys for Plaintiff-Appellee*
*Cross-Appellant*

## OPINION OF THE COURT

(Filed October 10, 1980)

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R. LANIER ANDERSON, III, *Circuit Judge:*

In this case General Portland Cement Co. (sometimes referred to as taxpayer) filed suit for refund of federal income taxes and assessed interest for the years 1960 through 1968 in the total amount of $2,178,046.42.

All of the issues before this court involve the percentage depletion deduction allowed by Section 613 of the Internal Revenue Code of 1954, as amended,[1] and all except the interest issue involve the proportionate profits method. The issues are: (1) the proper treatment under the proportionate profits method of certain items: the bagging premium and the costs of the bagging operation, and the costs of loading bulk cement and other distribution costs; (2) the proper treatment under the proportionate profits method of the discount offered by taxpayer to its customers for prompt payment, and (3) the proper treatment of certain items of interest income and expense in calculating the "50% limit."[2] The district court's decision, reported at 438 F.Supp. 27, sustained the government's position both with respect to the treatment of the cost of loading bulk cement and other distribution costs and with respect to the treatment of the bag premium and the costs of the bagging operations. With respect to these items, we affirm. The district court held for the taxpayer with respect to the proper treatment of the discount; we reverse that holding. The district court also held for the taxpayer to that issue, we affirm.

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[1] Hereafter in this opinion, reference to the Internal Revenue Code will simply be to section numbers, without further designation.

[2] Section 613(a) limits the percentage depletion deduction to 50% of the taxpayer's taxable income from the property.

Part I of this opinion will set out certain details concerning the manufacture of cement which we hope will contribute to an understanding of the issues. Part II will explain the mechanics of the percentage depletion deduction and the proportionate profits method. Parts III, IV, and V discuss respectively the three issues listed above. The facts relevant to each issue are set out in the part of the opinion discussing that issue.

## I. THE MANUFACTURE OF CEMENT

Taxpayer is an integrated mining and manufacturing company producing cement. In the production of cement, taxpayer generally extracts limestone (source of calcium carbonate), shale, and/or clay (source of silica, alumina and iron). These minerals are conveyed to a primary crush er which crushes the minerals. The crushed mineral is stockpiled near the cement plant along with other necessary minerals, which are either purchased or extracted from taxpayer's quarries. These materials then undergo a raw grinding process in which water is added to make a mixture having the appearance of mud. The product of this raw grinding process is called "slurry." The slurry is then pumped to large blending and storage tanks where it is continually agitated to keep the solids from settling and to keep the mixture homogeneous. The slurry is then moved from the blending and storage tank as "kiln feed" into a large rotary kiln where it is burned. Complex chemical reactions occur in the kiln, and a cement clinker results from this burning process. The cement clinker is cooled, and later the clinker, along with gypsum, is ground into finished cement. The finished cement is then conveyed to storage silos at the plant where it is stored until it is shipped by rail, barge, or truck, either directly to taxpayer's customers or to distribution terminals operated by taxpayer in cities other than those where taxpayer main-

tains plants. When cement has been transported to a distribution terminal, customers may take delivery there or it may be shipped to them from there. Taxpayer loads the bulk cement from the storage silo, located either at the plant or at a distribution terminal, directly into rail cars, barges, or trucks for shipment.

Approximately 10% to 20% of taxpayer's sales are in bags, rather than in bulk. Upon receiving an order for bagged cement, the finished bulk cement is conveyed from the storage silo to a bagging machine. After the bag is filled according to weight, the bagged cement is hand loaded onto a truck or rail car for shipment to the customer.

## II. PERCENTAGE DEPLETION DEDUCTION AND PROPORTIONATE PROFITS METHOD

The percentage depletion deduction provided by Section 613 is calculated by multiplying "gross income from mining" by the applicable rate.[3] If taxpayer mined his mineral and sold it in crude form at the mine, his "gross income from mining" would simply be his gross sales price. However, when a taxpayer uses his crude mineral in a manufacturing operation, he has no sales price for the mineral itself. The sales price of the manufactured product — cement in this case — cannot be used, because to do so would give the taxpayer an inflated deduction based on the price of the manufactured product, which includes the value of the crude mineral plus the value added by the manufacturing processes. The purpose of the percentage depletion deduction is to compensate a taxpayer for the exhaustion of his mineral, not for the exhaustion of his manufactured product. Therefore, the deduction is a percentage of "gross income from mining" rather than gross income from manufacturing. When the only sales price is a sale of a manu-

[3] For the years at issue, the applicable percentage depletion rates were 15% for limestone and clay, and 5% for shale.

factured product, the problem is how to calculate "gross income from mining." If the mineral were sold in crude form by other persons or corporations, there might be a "representative market price" for the mineral which could be used. Where there is no "representative market price," as in this case, the regulations[4] require the use of the proportionate profits method. This method apportions the gross income from the manufactured product between the mining phase and the manufacturing or nonmining phase in proportion that "mining costs" bear to "total costs."[5] The formula is expressed as follows:

$$\frac{\text{Mining costs}}{\text{Total costs (mining + nonmining)}} \times \text{Gross sales} = \text{Gross income from mining}$$

By apportioning gross income on the basis of the ratio of mining costs to total costs, the formula assumes that each item of cost produces a pro rata share of the profits.

Under the proportionate profits method, one crucial determination is ascertaining which are mining costs, and which are not. As a general matter, that determination is controlled, in the case of cement, by Section 613(c)(4)(F). That section provides:

> (4) *Treatment processes considered as mining.*— The following treatment processes where applied by the mine owner or operator shall be considered as mining to the extent they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under section 611:

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[4] Treas.Reg. 1.613–4(d). To the same effect was the Regulation in force during most of the years at issue, Treas.Reg. 118, § 39.23(m)–1(e)(3).

[5] Indirect costs which benefit the entire operation, e. g., overhead expenses, are usually allocated between mining costs and nonmining costs in the proportion that direct mining costs bear to total direct costs. Treas.Reg. 1.613–4(d)(4)(iii).

* * * * * *

> (F) in the case of calcium carbonates and other minerals when used in making cement — all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;

The statute provides that some treatment processes are considered part of mining. In the case of cement, the statute provides, and the parties agree, that mining includes all processes applied prior to the introduction of the kiln feed into the kiln, but does not include any subsequent process. This point at which the mining phase ceases and the manufacturing or nonmining phase begins is called the "cutoff" point.[6] In the first issue of the instant case, discussed in Part III, we are concerned with the proper treatment of certain costs incurred after the "cutoff" point.

The proportionate profits method begins with the sales price or gross income from the manufactured product (cement) and arrives at a constructive figure for the sales price of the mineral, namely, "gross income from mining." In this way the taxpayer is allowed a deduction based upon gross income attributable to his mining operations. It is apparent that the proportionate profits method includes within "gross income from mining" all mining costs and the pro rata profits attributable thereto, and, conversely, excludes from "gross income from mining" all nonmining costs and the pro rata profits attributable thereto.

In this opinion we sometimes refer to "gross income from mining" as taxpayer's depletable base, since taxpayer is entitled to a percentage depletion deduction based on "gross income from mining."

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[6] The mining phase includes all pre-kiln processes except preheating the kiln feed. Section 613(c)(4)(F). Because preheating is not in dispute in this case, we refer here to the "cutoff" point as being the point just before the kiln feed is introduced into the kiln.

## III. COSTS OF LOADING AND OTHER DISTRIBUTION COSTS, AND THE BAGGING OPERATION

### A. Facts and Posture of the Issues.

In this part of our opinion, we consider the proper treatment, in applying the proportionate profits formula, of the following items: (1) bag premium; (2) cost of the bags and cost of packing and loading the bags; (3) cost of loading bulk cement onto rail cars, barges, or trucks; and (4) cost of owning and operating the distribution terminals which taxpayer maintains for the purpose of having cement readily available for delivery in areas where taxpayer has no plant.[7]

A higher price was charged by taxpayer for cement sold in bags as compared to cement sold in bulk. This additional amount is known in the industry as a "bag premium." The amount of the bag premium during each of the years in question was approximately 40¢ to 60¢ per barrel, or 10¢ to 15¢ per bag. In setting and charging the bag premium, taxpayer intended to recover the additional costs incurred in placing the cement in bags, in order to realize a profit on bagged cement equal to the profit on bulk cement. Taxpayer's corporate headquarters, which set the amount of the bag premium, collected information concerning the cost of the bags and the cost of packing and loading the bags in order to determine the additional costs incurred in the bagging operation, and thereby established the amount of the bag premium. The parties stipulated that, during the years in issue, the amount of the bag premium charged by taxpayer did not exceed the cost of bags plus the additional costs incurred in packing and loading the cement in bags.

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[7] We refer in this opinion to the costs listed as (3) and (4) as the "costs of loading and other distribution costs."

With respect to the bag premium and the costs of the bagging operation, the taxpayer argues that the bag premium should be "nettted" against so much of the costs of the bagging operation as equals the amount of the premium and that both should be excluded from the proportionate profits formula.[8] The government argues that the bag premium should be included as part of the "gross sales" figure in the formula, and that the entire cost of the bagging operation is a "nonmining cost" and should be included in the denominator of the proportionate profits fraction. The treatment sought by taxpayer, while it would reduce the "gross sales" figure (which would seem adverse to taxpayer), would decrease the denominator of the fraction, thereby increasing the fraction, and would result in an overall increase in "gross income from mining." Thus, taxpayer's percentage depletion deduction would be increased. The district court sustained the government's position, and we agree.

With respect to the costs of loading and other distribution costs, the taxpayer argues first that these costs are indirect costs which benefit the entire operation and therefore should be allocated in part to "mining costs" and in part to "nonmining costs." Recalling the formula, it is apparent that this treatment would, as compared to treating such costs entirely as "nonmining costs" as the government urges, decrease the denominator and therefore increase the fraction by which "gross sales" is multiplied, increase "gross income from mining," and therefore increase taxpayer's percentage depletion deduction. The district court sustained the government's position, holding that such costs are entirely nonmining costs. We agree. The district court also rejected taxpayer's alternative argu-

[8] Taxpayer would treat the excess of the bagging costs over the amount of the premium in the same manner taxpayer urges for the loading and other distribution costs, i. e., either allocated between the mining and nonmining phases or, alternatively, simply excluded from the formula.

ment that such costs should simply be excluded from the formula. The effect of excluding these costs (which would otherwise be nonmining) is to reduce the denominator of the fraction, thereby increasing the fraction and ultimately increasing the percentage depletion deduction. We also affirm the district court's rejection of this alternative argument.

Our discussion in Part III will include: in Subpart B, a discussion of the applicability of the 1968 regulations; in Subpart C, an analysis of the controlling case law and the proportionate profits regulation in effect in taxable years 1960 through 1967; in Subpart D, the application of the controlling law to the bag premium and the costs of the bagging operation; and in Subpart E, the application of the controlling law to the costs of loading and other distribution costs.

B. Application of 1968 Regulations

In July 1968, regulations were promulgated[9] which provide in pertinent part as follows:

*Reg. 1.613 — 3(b)(1)*

* * * *

> For the purpose of this section, "ordinary treatment processes" (applicable to the taxable years beginning before January 1, 1961) and "treatment processes considered as mining" (applicable to the taxable years beginning after December 31, 1960) will be referred to as "mining processes." Processes, including packaging and transportation, which do not qualify as "mining" will be referred to as "nonmining processes."

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[9] T.D. 6965, 1968 – 2 C.B. 265 (1968). These regulations were later incorporated without substantial change as part of § 1.613–4 of the current regulations. Elsewhere in our opinion we sometimes refer to the current regulations.

*Reg. 1.613—3(d)(1)(iv)*

As used in this section, the term "first marketable product or group of products" means the product (or group of essentially the same products) produced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing area. For this purpose, bulk and packaged products are considered to be essentially the same product. . . .

For example, if a cement manufacturer sells his own finished cement of various types in bulk and bags and also sells concrete blocks or dry ready-mix aggregates containing additives, the finished cement of various types, in bulk and bags, constitutes the first marketable product or group of products produced by him.

*Reg. 1.613—3(d)(4)(i)*

Except as specifically provided elsewhere in this section, when determining gross income from the property by use of the proportionate profits method or any other approved method which is based on the taxpayer's costs, the costs attributable to mining transportation shall be treated as mining costs, and the costs attributable to nonmining transportation shall be treated as nonmining costs. Accordingly, except as specifically provided elsewhere in this section, all profits attributable to mining transportation shall be treated as mining profits, and all profits attributable to nonmining transportation shall be treated as nonmining profits. For this purpose, mining transportation means so much of the transportation of ores or minerals (whether or not by common carrier) from

the point of extraction from the ground to plants or mills in which other mining processes are applied thereto as is not in excess of 50 miles.

*Reg. 1.613 — 3(d)(4)(iii)*

In determining gross income from the property by use of the proportionate profits method (or any other approved method which is based on the taxpayer's costs) —

*(a)* The costs attributable to containers, bags, packages, pallets, and similar items as well as the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

*(b)* The costs attributable to the bulk loading of manufactured products shall be considered as nonmining costs.

*(c)* The costs attributable to the operation of warehouses or distribution terminals for manufactured products shall be considered as nonmining costs.

Accordingly, all profits attributable thereto are treated as nonmining profits.

*Reg. 1.613 — 3(g)(3)*

Transportation the primary purpose of which is marketing, distribution, or delivery for the application of only nonmining processes shall not be considered as mining.

The quoted regulations (hereinafter referred to as the 1968 Regulations) deal specifically with the issues relating to the bag premium, the cost of bagging, loading costs, and the costs of operating terminal facilities. In each case the regulations clearly dictate the result favored by the govern-

ment, i. e., that bag cement, as well as bulk cement, be treated as the first marketable product and therefore that bag premiums be included in the proportionate profits as part of gross sales, and that bagging costs, loading costs, and the costs of operating terminal facilities be treated as nonmining costs.

The government urges that the 1968 Regulations, which purport to apply to all taxable years governed by the Internal Revenue Code of 1954, should be retroactively applied to all of the taxable years at issue here. Noting that the Ninth Circuit, in *United States* v. *California Portland Cement Co.,* 413 F.2d 161 (1969), [hereinafter cited as *California Portland*] did apply these regulations retroactively, the government argues that these regulations meet the test for retroactive application enunciated by this circuit in *Anderson, Clayton and Co.* v. *United States,* 562 F.2d 972 (5th Cir. 1977), *rehearing en banc denied,* 565 F.2d 1215 (1977), *cert. denied,* 436 U.S. 944, 98 S.Ct. 2845, 56 L.Ed.2d 785. Because we reach the same result considering only the pre-1968 Regulations and the applicable case law, we do not reach the question of the retroactive application of the 1968 Regulations. However, it is clear that the 1968 Regulations do govern the last taxable year here involved, the calendar year 1968. With respect to that year, we affirm the decision of the district court, with respect to the treatment of bag premiums, bagging costs, loading costs, and the costs of operating terminal facilities, on the authority of the 1968 Regulations.

Our consideration of the remaining taxable years, i. e., calendar years 1960-1967, will be based on the regulations[10] in effect before the 1968 Regulations, and the applicable case law.

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[10] Treas.Reg. 118, § 39.23(m)–l(e)(3).

C. Primary Case Law and the Proportionate Profits Regulation.

A review of the four cases which have considered the proper handling of the bag premium, the costs of bagging, and the costs of loading and other distribution costs will aid our resolution of the issues before us. Taxpayer places primary reliance upon *United States v. Ideal Basic Industries, Inc.*, 404 F.2d 122 (10th Cir. 1968), *cert. denied* 395 U.S. 936, 89 S.Ct. 1997, 23 L.Ed.2d 451 [hereinafter cited as *Ideal Basic*].[11] That case dealt with items identical to those at issue here—bag premium, cost of bagging, cost of loading bulk cement, and the costs of warehouses and distribution terminals — in the context of the proportionate profits method. The Tenth Circuit held that the bag premiums and all of the aforesaid cost items should be excluded from the proportionate profits formula. The reasoning employed by the court was: first, that bagging, loading, transportation to warehouses and distribution terminals, and warehousing are nonmining expenses which relate to the manufactured product (bulk cement) and not to the mining of the crude mineral (kiln feed); and second, that therefore these items must simply be excluded from the formula. We agree with the first step of this reasoning,[12] but not the second step. As authority for the second step, the *Ideal Basic* court simply cites *Standard Lime and Cement Co. v. United States*, 329 F.2d 939, 165 Ct. Cl. 180 (1964) [hereinafted cited as *Standard Lime*].[13]

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[11] In *Portland Cement Co. of Utah v. Comm'r*, 614 F.2d 724 (1980), the Tenth Circuit recently followed its *Ideal Basic* decision.

[12] Accord *California Portland; Whitehall Cement Mfg. Co. v. United States*, 369 F.2d 468 (3rd Cir. 1966).

[13] The *Ideal Basic* court also cited *United Salt Corp. v. Comm'r*, 40 T.C. 359 (1963), *affirmed* 339 F.2d 215 (5th Cir. 1964), as secondary authority. Because *United Salt* involved the determination of the "first marketable product" in a context different from the proportionate profits method, the case is inapposite. See discussion in subpart D.

Our discussion below will demonstrate why we believe this reliance on *Standard Lime* was misplaced.

In *California Portland,* the Ninth Circuit considered the proper treatment of bag premiums and the cost of bags and bagging in applying the proportionate profits method. It held that the premium and the bagging costs must be included in the formula and that the bagging costs should be considered nonmining costs. 413 F.2d at 169. The court also reversed the district court's conclusion that bulk cement was the first marketable product, holding that the first marketable product was merely cement with no distinction as to the form of packaging. Although the Ninth Circuit held that the 1968 Regulations were retroactive and clearly required this result, it also held that the 1939 Regulations and the applicable case law lead to the same result.[14] The court relied on *Whitehall Cement Manufacturing Co. v. United States,* 369 F.2d 468 (3rd Cir. 1966) [hereinafter cited as *Whitehall*], and expressly rejected *Ideal Basic.*

In *Whitehall* the Third Circuit considered the proper treatment, in the proportionate profits context, of the costs of loading bulk cement onto rail cars and trucks, and the proper treatment of bag premiums and costs. The court rejected the taxpayer's argument that bag premiums and the costs of bagging and loading should be excluded from the proportionate profits formula. The *Whitehall* court also considered finished cement, without distinction as to packaging, to be the first marketable product. 369 F.2d at 471. The court rejected taxpayer's "erroneous assumption" that its bagging costs produced only the premium revenue,

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[14] This is not merely an alternative holding. Two of the taxable years involved, fiscal years 1953 and 1954, were prior to the retroactive effective date of the 1968 Regulations, and therefore were controlled only by the 1939 Regulations and applicable case law. 413 F.2d at 164.

finding instead that it was reasonable to infer that taxpayer's sale of bagged cement was an accommodation to customers, induced such sales, and at least partially contributed to substantial profits. 369 F.2d at 474. The court treated the loading and bagging costs as nonmining costs. 369 F.2d at 473, 474.

Both the taxpayer and the government rely on *Standard Lime*. Although the language used by the Court of Claims has undoubtedly and understandably misled the taxpayer, we conclude that the holding of the case supports the government's position here. *Standard Lime* did say that "packing and loading costs are indirect costs which are not incurred for the benefit of the entire operation and as such cannot be included in taxpayer's computation of gross income from the property at kiln feed." 329 F.2d at 948. With regard to the cost of bags and the other costs incurred in the bagging operation, the court said: "Thus, the entire amount of this expense must be eliminated from the computation for the same reason that packing and loading costs of bulk cement (and a percentage of the total profits attributable to them) must be excluded from the computation as an indirect cost which is not incurred for the benefit of the entire mining — manufacturing operation." 329 F.2d at 949. This is the language that has led the taxpayer astray. To understand this language, it is necessary to analyze carefully the particular proportionate profits formula which was being used by the Court of Claims and to understand how the formula used by the Court of Claims differs from the formula we apply. Gross income from mining was referred to as "gross income from the property at kiln feed point" and was computed by adding items (a), (b), and (c):

(a) Total direct cost up to kiln feed;

(b) Percentage of indirect cost allocable to process up to kiln feed, calculated as follows:

$$\frac{\text{Direct cost up to kiln}}{\text{Total processing direct costs}} \times \text{Indirect costs which can be allocated}$$

(c) Percentage of net profits allocable to kiln feed.

Item (c), the percentage of net profits allocable to kiln feed, is in turn calculated as follows:

(i) Gross income from end product (sales price × units sold)

(ii) Less Total costs in producing end product

(iii) Profit from entire operation

(iv) Less Profit attributable to indirect costs which cannot be allocated

(v) Allocable net profit

(vi) $\frac{\text{Direct cost up to kiln}}{\text{Total processing direct costs}} \times \text{Allocable net profit} = \text{Net profit allocable to kiln feed}$

Step (iv) in item (c) of the *Standard Lime* formula is the crucial step in the computation by which that court eliminated from the depletable base the profits attributable to the costs of loading and distribution and the costs of the bagging operation. The *Standard Lime* court labeled these costs as indirect costs which did not relate to the mining phase and which were not incurred for the benefit of the entire operation. Applying the formula, such costs are "indirect costs which cannot be allocated" and thus are not included in item (a) or in item (b),[15] and the propor-

[15] Although the *Standard Lime* formula properly excludes from the depletable base all of the cost items at issue here and also the proportionate profits attributable thereto, thus accomplishing the major goal sought by the government in the instant case, the *Standard Lime* treatment is different from the treatment urged

tionate profits attributable to these costs are excluded from the depletable base by step (iv). This exclusion properly results in a figure for the depletable base which includes only the cost up to the kiln feed, i.e., mining costs, and the profits attributable thereto, and which accordingly excludes loading and bagging costs and the profits attributable thereto. Thus, the exclusionary language is proper with respect to the particular *Standard Lime* formula.

Taxpayer's error arises when it transposes *Standard Lime's* exclusionary language to the very different formula being used in this case. Both parties in this case use the following formula:

$$\frac{\text{mining costs}}{\text{total costs (mining + nonmining)}} \times \text{gross sales} = \text{gross income from mining}$$

Had the *Standard Lime* court used the above formula, it would have included the pertinent costs as part of the "total costs" in the denominator, because the court clearly held that the costs did not relate to the mining phase and were not allocable in any part of the mining phase. To ac-

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by the government in one respect. Item (b) of the *Standard Lime* formula determines the allocation between the mining and nonmining phases of "indirect costs which can be allocated." The prime example of such indirect costs is overhead expenses (we will refer to all allocable indirect costs by the shorthand term "overhead expenses"). Item (b) of the formula makes this allocation by multiplying such "overhead expenses" by a fraction, the numerator of which is "*direct* costs up to kiln" and the denominator of which is "total processing *direct* costs." As note 19, 329 F.2d at 948, makes clear, the *Standard Lime* court's labeling of the cost items at issue as "indirect" means that these costs are eliminated from the denominator of item (b)'s fraction. This, of course, results in a larger amount of "overhead expenses" being allocated to the mining phase. The effect of this particular aspect of the *Standard Lime* formula is to allocate "overhead expenses" only to the "direct" mining phase and the "direct" manufacturing-nonmining phase, thus making no allocation of "overhead expenses" to distribution and marketing operations. We believe it is erroneous to assume that "overhead expenses" are not related at all to distribution and marketing operations. We doubt that the *Standard Lime* court intended to do this. For these reasons, we reject this particular quirk in the *Standard Lime* formula.

complish that result one would have to *include* the costs at issue in the denominator of the fraction of the formula being used here, thus decreasing the fraction, and, when the smaller fraction is multiplied by "gross sales," accomplishing the removal of such costs and their pro rata profits from "gross income from mining." Thus, inclusion in the denominator of our formula accomplishes the same thing as exclusion from the *Standard Lime* formula.[16]

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[16] The example set out in the Appendix to the government's post-argument brief demonstrates that the *Standard Lime* formula and treatment of the pertinent items urged by the government in the instant case produce the same depletable base, namely $50,000.

EXAMPLE

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|---|---|
| Direct Mining Costs | 40,000 |
| Costs of Loading Bulk Cement* | 5,000 |
| Costs of Loading Bagged Cement* | 5,000 |
| Cost of Bags* | 10,000 |
| Other Direct Nonmining Costs | 20,000 |
| "Bag Premium" | 15,000 |
| Sales Receipts Net of "Bag Premium" | 85,000 |

*Labeled by *Standard Lime* as indirect cost which cannot be allocated.

I

Fractional Formula used in instant case

$$\frac{\text{Mining Costs}}{\text{Total Costs}} \times \text{Gross Sales} = \text{Gross Income from Mining}$$

$$\frac{40{,}000}{40{,}000 + 5{,}000 + 5{,}000 + 10{,}000 + 20{,}000} \times (15{,}000 + 85{,}000) = \underline{\underline{50{,}000}}$$

II

Standard Lime Formula

(a) Total direct cost up to kiln feed

(b) Percentage of direct cost *allocable to process up to kiln feed*, computed as follows:

$$\frac{\text{Direct cost up to kiln feed}}{\text{Total processing direct costs}} \times \begin{matrix}\text{Indirect costs} \\ \textit{which can be} \\ \textit{allocated}\end{matrix}$$

(c) Percentage of net profits allocable to kiln feed [computed as follows:]

(i) Gross income from end product (sales price × units sold)

(ii) Less total costs in producing end product

(iii) Profit from entire operation

(iv) Less profit attributable to indirect costs which cannot be allocated**

(v) Allocable "net" profit

(vi) $\frac{\text{Direct cost up to kiln}}{\text{Total processing direct costs}} \times \text{Allocable net profit} = \text{Net profits allocable to kiln feed}$

**Eliminated from total profit on the ratio which the cost of these "indirect expenses" which cannot be allocated bears to total cost of producing cement. 329 F.2d at 945, n. 13.

(a) 40,000

(b) 0 (None of the loading or bagging costs were incurred for the benefit of the mining phase, nor benefited the entire operation, and therefore cannot be allocated.)

(c) See below

(i) 100,000

(ii) − 80,000 (40,000 + 5,000 + 5,000 + 10,000 + 20,000)

(iii) 20,000

(iv) − 5,000 $\left(\frac{5{,}000 + 5{,}000 + 10{,}000 \text{ (indirect nonallocable costs)}}{(40{,}000 + 5{,}000 + 5{,}000 + 10{,}000 + 20{,}000 \text{ (total costs)})} \times 20{,}000 \text{ (total profit)} = 5{,}000\right)$

(v) 15,000

(vi) 10,000 $\left(\frac{40{,}000}{(40{,}000 + 20{,}000} \times 15{,}000\right)$

(c) Step (vi), $10,000, is the computed result for item (c), percentage of net profits allocable to kiln feed.

Summary of *Standard Lime* formula:

(a) $40,000
(b) 0
(c) 10,000
Total $50,000

On the basis of the above analysis, we conclude that the Tenth Circuit in *Ideal Basic* improperly relied upon *Standard Lime*. With respect, we believe that the *Ideal Basic* court was misled by the exclusionary language utilized by the *Standard Lime* court in applying its very different formula. We also believe that exclusion of the cost items at issue here, as *Ideal Basic* would require, would violate the purpose of the proportionate profits method. The effect of such exclusion would be to eliminate such costs from the denominator of our formula's fraction, thereby increasing the fraction. When the fraction is then multiplied by the "gross sales"[17] figure, the effect is to include in the depletable base the costs at issue and the profits attributable thereto.[18] Thus, although the Tenth Circuit properly classifies the cost items at issue as relating only to the manufacturing or nonmining phase, its treatment of the items fails to accomplish the purpose of the proportionate profits method, i. e., elimination of such nonmining costs and their proportionate profits from the depletable base.[19]

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[17] "Gross sales" includes total costs plus total profits.

[18] The fact that the *Ideal Basic* solution would exclude from the "gross sales" figure the bag premium is small consolation. That exclusion might be considered as reducing the depletable base by so much of the cost items as equals the premium, but still the profits attributable to such excluded costs would be left in the depletable base.

[19] The failure of the *Ideal Basic* solution can readily be seen when one notes that the Tenth Circuit's computation began with the sales price of bulk cement as the "gross sales" figure in the formula. This price is obviously designed to cover the costs of loading the cement, transporting it to warehouses, and the cost of warehousing, because no separate charges are made to recover such costs. However, the computation does not in any way accomplish a reduction of this sales price by the amount of these cost items or by their pro rata profits. Thus, although the Tenth Circuit classified these costs as nonmining, it left them, and their profits, in the depletable base as if they were mining costs.

The proportionate profits regulation in effect[20] during taxpayer's calendar years 1960 through 1967 was Treas.Reg. 118, § 39.23(m)—(1)(e)(3), which provides in part:

> If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude mineral state is merely transported, the price for which sold) minus the costs and proportionate profits attributable to the transportation (other than transportation treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes. If the taxpayer establishes to the satisfaction of the Commissioner that another method of computation, other than the computation, of profits proportionate to costs, clearly reflects the gross income from the property, then such gross income shall be computed by the use of such other method.

We will apply the principles derived from the above cases to, and analyze the import of the foregoing regulation on, the bagging operation in subpart D, and then the costs of loading and other distribution costs in subpart E.

D. Bagging Operation

[1] With respect to the bagging operation, taxpayer makes several arguments. First, taxpayer argues that its bagging operation produces no profit, and therefore the bag premium and bagging costs should be excluded from

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[20] This regulation was originally promulgated under the Internal Revenue Code of 1939, but was continued in force under the 1954 Code until superseded by the 1968 Regulations, pursuant to § 7807(a) of the Internal Revenue Code of 1954, and TD 6091, 1954–2 C.B. 47.

the proportionate profits formula.[21] The argument is that the proportionate profits formula assumes that each item of cost produces a pro rata share of the profits, that the evidence shows that the bag premium was designed simply to reimburse the costs of bagging and therefore shows that the bagging operation was a break-even operation, and that it would undermine the purpose of the proportionate profits method to include in the formula such a break-even operation. We reject taxpayer's argument.

We do not accept taxpayer's premise that the bagging operation produces no profit. Taxpayer's proof that the bag premium was designed simply to reimburse the costs of bagging does not constitute proof that the bagging operation produces no profit. The Third Circuit in *Whitehall,* 369 F.2d at 474, disposed of the same contention with these words:

> There is implicit in the plaintiff's argument an erroneous assumption that the packaging costs produced only the additional revenue derived from the premiums . . . The sale of cement in bags was presumably an accommodation to those customers whose particular requirements were such as to make the purchase of cement in bulk commercially unfeasible. The availability of packaged cement was undoubtedly a sales inducement to such customers. It seems reasonable to infer that the profits realized from the sale of packaged cement, and these were substantial, were attributable at least in part to the packaging costs.

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[21] Taxpayer would "net" the bag premium against an equal amount of bagging costs and exclude both amounts entirely from the formula. With respect to the excess of the bagging costs over the premium, taxpayer argues this excess should receive the same favorable treatment (discussed below in subpart E) it urges for the loading and other distribution costs.

Taxpayer concedes as much in its brief. Taxpayer notes that the bag premium was intended to recover the additional costs incurred in the bagging operation, as compared to bulk sales, "in order to realize a profit on the bagged cement equal to the profit on bulk cement."[22]

In any event, had taxpayer believed that the proportionate profits method created a distortion, it could have taken advantage of the provision in the regulations which permit application to the Commissioner to obtain permission to use some other formula in lieu of the proportionate profits formula.[23] There is no evidence that taxpayer made such application. To the contrary, taxpayer has proceeded, both in the filing of its tax returns and in the conduct of this case, on the assumption that the proportionate profits method applies.

The taxpayer's next argument turns on a determination of what is the "first marketable product" in the production of cement. Treas.Reg. 118, § 39.23(m)—1(e)(3) provides in pertinent part:

> If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the *first marketable product* resulting from any process or processes (or, if the product in its crude mineral state is merely transported, the price for which sold) minus the costs and proportionate profits attributable to the transportation (other than transportation treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes.

(emphasis added) Relying on the regulation, taxpayer argues that bulk cement is the first marketable product, and

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[22] Taxpayer's brief, p. 13.

[23] Treas.Reg. 118, § 39.23(m)–1(e)(3) provides for such application.

that the price of bulk cement should be the starting point. Since the bag premium would thereby be eliminated from the proportionate profits formula, taxpayer concludes that the costs of the bagging operation should likewise be excluded.[24] Taxpayer relies on the Tenth Circuit case, *Ideal Basic.*

On this issue, we are faced with a direct conflict among the circuits. As is apparent from our discussion in subpart C, *Ideal Basic* squarely supports taxpayer's position, both in labeling bulk cement as the "first marketable product" and in excluding the bag premium and bagging costs from the proportionate profits formula. The Ninth Circuit, in *California Portland,* rejected the taxpayer's position that bulk cement was the "first marketable product," expressly rejected the *Ideal Basic* holding and rationale, and held that the bag premium and bagging costs should be included in the proportionate profits formula, and that bagging costs should be considered nonmining costs. In other words, *California Portland* squarely supports the government's position in this case. So also does the Third Circuit in *Whitehall.* As our discussion in subpart C demonstrates, the Court of Claims decision in *Standard Lime* also supports the government position here, although some of its language was understandably misleading. Having concluded in subpart C that *Ideal Basic* is not persuasive authority because of its misplaced reliance upon *Standard Lime* and because its solution does not comport, with the purpose of the proportionate profits method, we conclude that *California Portland, Whitehall* and *Standard Lime* set forth the correct law.

Before completing our discussion, we inquire whether some support for taxpayer's position can be found in sev-

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[24] Thus, taxpayer would "net" the premium against an equal amount of bagging costs and exclude both from the formula.

eral older cases[25] which, although they did not involve the proportionate profits method, did consider bagging costs in the context of determining the "first marketable product" and the depletion "cutoff" point under the pre-1960 law. Under that prior law, a taxpayer's percentage depletion was based upon its mining operations up to a "cutoff" point which was defined in the statute as including ordinary treatment processes to obtain the "first marketable product." In several such cases, the courts determined that the "first marketable product," i. e. the "cutoff" point, preceded the bagging operation, a determination that would seem to provide some support for taxpayer's position that bulk cement is the "first marketable product."[26] The Ninth Circuit, in the *California Portland* case, however, distinguished such cases with the following language:

> [T]he courts were not applying the proportionate profits method, as we are here, for there was a representative market price for the crude mineral product. Instead, the courts were concerned only with determining the cutoff point at which mining ceased and, faced with this question, they held that the taxpayers were not entitled to include the costs of bagging in their gross income, because bagging was not a cost of mining. If

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[25] *United Salt Corp. v. Comm'r,* 40 T.C. 359 (1963) *aff'd* 339 F.2d 215 (5th Cir. 1964); *Standard Realization Co. v. United States,* 289 F.2d 247 (7th Cir. 1961); *Riddell v. Victorville Lime Rock Co.,* 292 F.2d 427 (9th Cir. 1961); *Townsend v. Hitchcock Corp.,* 232 F.2d 444 (4th Cir. 1956); *United States v. Utco Products,* 257 F.2d 65 (10th Cir. 1958); *Comm'r v. American Gilsonite Co.,* 259 F.2d 654 (10th Cir. 1958); *North Carolina Granite Corp.,* 43 T.C. 149 (1964); *Int'l Talc Co. v. Comm'r,* 15 T.C. 981 (1950).

[26] To the extent that these cases support the contention that bulk cement is the "first marketable product," they lend some weight to taxpayer's argument that the proportionate profits regulation requires that the computation begin with "gross sales" of the bulk cement, thus excluding from the formula the bag premium and an equal amount of bagging costs.

> there were a representative market price for the ground calcium carbonate [i. e., kiln feed], we would not resort to the proportionate profits method in the present case, and would then exclude *all* nonmining costs from the computation.

413 F.2d at 169 (emphasis in original). To elaborate on the distinction made by *California Portland,* if there were a representative market price for the mineral at issue here at the "cutoff" point, i. e., kiln feed, then we would not be required to use the proportionate profits method.[27] However, the parties have agreed that there is no representative market price for kiln feed, and that the proportionate profits method is applicable. When the proportionate profits method is used, one cannot simply eliminate the cost items themselves; the proportionate profits attributable to those costs must also be eliminated. It is this step that taxpayer seeks to avoid.

We think the "cutoff" point cases are inapposite for another reason. Even if we assume, with those cases, that bulk cement is the first marketable product, it does not follow therefrom that bagged cement is a separate or different product. That is, it does not follow that bagged cement is the second marketable product.[28] Rather, bagging is simply a way of getting the same product, namely cement, to market. Some customers might want cement in rail cars, some in trucks, some in barges, some in "piggy-back" containers, and some in bags. The product, however, remains

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[27] Taxpayer acknowledges, in its Reply Brief, page 9, that it would be comparing "apples" and "oranges" to compare the first marketable product in the "cutoff" point context with the same term in the proportionate profits context.

[28] We reject the Tenth Circuit's label when it called bagged cement the second marketable product. *Ideal Basic,* 404 F.2d at 126.

cement.[29] Bagging, then, does not create a different product. It is an expense very similar to the expense of transporting the product to market. Treas.Reg. 118, § 39.23(m)—1(e)(3), the regulation setting out the proportionate profits method, specifically provides that transportation costs and their proportionate profits shall reduce the depletable base. By analogy to the regulation's treatment of transportation costs, we believe that bagging costs and their proportionate profits should reduce the depletable base. The regulation, therefore, supports our conclusion that the "cutoff" point cases provide no authority with respect to the proper treatment of cost items in applying the proportionate profits method.

We therefore conclude that the persuasive authority is found in *California Portland, Whitehall* and *Standard Lime.* We hold that the bag premiums should be included in the "gross sales" figure of the formula, and that the full costs of bagging should be included in the denominator of the fraction as "nominating costs."[30] Our treatment rejects taxpayer's attempt to "net" the bag premium against an equal amount of bagging costs and exclude both from the formula, because the effect of taxpayer's attempt would be to *fail* to exclude from the depletable base the profits attributable to the bagging costs thus excluded, and because the purpose of the proportionate profits would be undermined to the extent of that failure.[31] Our treatment

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[29] Accord, *California Portland,* 413 F.2d at 169, 175; *Whitehall,* 369 F.2d at 471.

[30] We hold that the bagging costs are nonmining costs for the same reasons, discussed in subpart E, that loading and other distribution costs are nonmining costs.

[31] In other words, taxpayer's attempt to "net" the bag premium against an equal amount of bagging costs would decrease "nonmining costs" by the amount of the excluded bagging costs, thereby reducing the denominator of the proportionate profits fraction by the amount of the excluded costs, and thus increasing

will remove from the depletable base *all* bagging costs and *all* profits attributable thereto, and thus will serve the purposes of the proportionate profits method, i. e., to remove from the depletable base all nonmining costs and all profits attributable thereto.

E. Costs of Loading Cement in Bulk and Other Distribution Costs

**[2]** With respect to the costs of loading bulk cement and the costs of operating terminal facilities, taxpayer's primary argument is that these expenses benefit the entire operation and, therefore, should be allocated between the mining and nonmining phases of its operations. Alternatively, taxpayer argues, relying upon *Ideal Basic,* that such costs should simply be excluded from the proportionate profits formula.

We reject taxpayer's primary argument, and hold that these costs do not benefit the entire operation, but rather are related directly to the nonmining phase of taxpayer's operations. Section 613(c)(4)(F) provides that treatment processes shall be considered as part of the mining phase up to the "cut-off" point, "but not including any subsequent process." The language implies that post-cutoff point "processes" are included in the nonmining phase. Taxpayer concedes as much. Taxpayer maintains, though, that these costs are distribution expenses, and not "processes." Taxpayer's argument is that mining processes occur up to the "cutoff" point, that thereafter manufacturing or nonmining processes occur (e. g., the heating in the kiln, the cooling and grinding of the clinker into finished cement), but that these manufacturing processes cease when the manufac-

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the fraction. When the increased fraction is then multiplied by "gross sales," the result is to *leave in* the depletable base (i. e., "gross income from mining") the profits attributable to such excluded costs.

tured product, i. e., cement, emerges. Thereafter, taxpayer argues, its expenses are distribution expenses which benefit the entire operation, and therefore should be allocated between the mining and nonmining phases. It is significant that taxpayer cites no cases to support this particular treatment of such cost items.[32] On the other hand, three cases oppose taxpayer's treatment. In *Whitehall,* the Third Circuit treated the cost of loading bulk cement into freight cars and trucks as a nonmining cost. In *Standard Lime*, the Court of Claims held that such loading costs and warehousing costs were distribution expenses which did not benefit the mining operations, which did not benefit the entire operation, and therefore no part of which could be allocated to the mining phase. In *California Portland*, the

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[32] Although *Ideal Basic* holds that similar distribution costs are to be excluded entirely from the proportionate profits formula, rather than allocated as taxpayer here argues, the Tenth Circuit case does contain language supportive of taxpayer's argument that the manufacturing-nonmining processes cease when cement emerges. See 404 F.2d at 126. For the reasons stated in the text immediately below, we decline to follow this implication in *Ideal Basic.*

Language in *Standard Lime* would seem superficially to support taxpayer's position. The Court of Claims accepted the "uncontradicted opinion" of that taxpayer's expert witness and found "that the post-kiln feed processes end at the point where the materials in the form of cement come to rest in the storage silos." 329 F.2d at 944–45, n.12. Accordingly, the Court of Claims labeled such costs as "indirect" expenses, as opposed to direct processing costs. However General Portland can take little comfort in the *Standard Lime* label because, as discussed in subpart C, the Court of Claims held that these indirect costs did *not* benefit the entire operation and therefore no part of these costs could be allocated to the mining phase. Logically and properly, the *Standard Lime* court reduced the depletable base by the amount of these costs and the proportionate profits attributable thereto. Thus, the *Standard Lime* court, applying its very different formula, achieved the major goals sought by the government here in its classification of these costs as "nonmining" costs.

Ninth Circuit held that the cost of bagging cement was a nonmining cost.[33]

In addition, the history of the relevant statute and regulations suggests that such costs are *processes*. Section 613(c)(4) provides that "loading for shipment" is an allowable "treatment process" for several named minerals and other "ores or minerals which are not customarily sold in the form of a crude mineral product." This same language, suggesting that "loading for shipment" is a *process*, appeared in the predecessor statute.[34] Similar language appears not only in the current regulations[35] but also in the regulations issued under the Internal Revenue Code of 1939.[36] Also, Section 613(c)(2), both before and after the 1960 amendments, included within the definition of mining so much of the transportation of the mineral from the mine to the processing plant as is not in excess of 50 miles. The regulations have contained similar provisions.[37] Thus, we see that other portions of the same statute, and regulations thereunder, treat loading for shipment and transportation of the mineral as "processes." This history of the statute and regulations persuades us that the loading and distribution costs at issue are "processes," and do not cease to be "processes," as taxpayer urges, simply because they occur after the manufactured product, cement, emerges.

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[33] Although bagging cement is a different physical process from loading bulk cement and operating distribution facilities, it is similar in that all are part of the process of delivering the product to the customer. The applicable principles are the same.

[34] Section 114(b)(4)(B) of the Internal Revenue Code of 1939.

[35] Treas.Reg. § 1.613–4(d)(2) and (f)(2).

[36] Treas.Reg. 118, § 39.23(m)–1(f)(1).

[37] Treas.Reg. 118, § 39.23(m)–1(e)(2); Reg. 1.613–4(f)(iii). Cf. also Treas.Reg. § 1.613–4(g)(3) which provides that transportation for the purpose of marketing and distribution is nonmining.

More importantly, to allocate or exclude loading and distribution costs from the proportionate profits formula would be to treat these costs differently from similar costs which clearly must be attributed to nonmining phases. The regulation in effect for all taxable years at issue except 1968, Treas.Reg. 118, § 39.23(m)—1(e)(3), specifically provides that transportation costs and the proportionate profits attributable thereto shall reduce the depletable base. The regulation provides in pertinent part:

> If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude mineral state is merely transportated, the price for which sold) *minus the costs and proportionate profits attributable to the transportation* (other than transportation treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes.

(emphasis added) We do not believe there should be a difference in treatment between the loading and distribution costs at issue — i.e., the cost of loading bulk cement onto a truck and the cost of operating terminal facilities to which the truck delivers the cement — on the one hand, and the sandwiched transportation costs — i.e., the costs of trucking the cement after the loading and before delivery to the terminal — on the other hand. If such transportation costs are to reduce the depletable base, as the proportionate profits regulation provides, then so also should the loading and terminal facility costs which occur, respectively, immediately before and after that transportation.

On the basis of the case law, the regulations, and the history of the statute and regulations, we reject taxpayer's primary argument and hold that the loading and distribu-

tion costs at issue here are post "cutoff" point processes, and are therefore nonmining costs.

Taxpayer's alternative argument, that the loading and other distribution costs should simply be excluded from the proportionate profits formula, relies upon the Tenth Circuit case, *Ideal Basic*. In subpart C we concluded that *Ideal Basic's* reliance on *Standard Lime* was misplaced and that its treatment of the cost items at issue violated the purpose of the proportionate profits method. We, therefore, reject taxpayer's attempt to exclude these cost items from the formula. We follow the holdings of *California Portland, Whitehall* and *Standard Lime;* we follow the implications in Reg. 39.23(m) — 1(e)(3), and in the history of the statute and regulations as discussed above. We hold that the loading and distribution costs at issue are nonmining costs. This will accomplish the purpose of the proportionate profits method, i.e., the exclusion of these nonmining costs and their pro rata profits from the depletable base.

## IV. DISCOUNT ISSUE

**[3]** During each of the taxable years at issue here, the taxpayer offered a discount to its customers. For the first taxable year, 1960, and part of 1961, the discount was 10¢ per barrel for gray cement and 20¢ per barrel for white cement. In 1961, the discount was increased to 20¢ per barrel for gray cement and 40¢ per barrel for white cement. It remained at this level for the succeeding taxable years. Until January 1, 1964, the terms of the discount required payment of the discounted price within 15 days from the invoice date, or payment of the full price within 30 days of the invoice date. The terms were changed effective January 1, 1964, and for 1964 and succeeding taxable years, the terms of the discount required payment of the discounted price by the 10th of the month for shipments invoiced

during the previous month, or payment of the full price by the last day of that month.

The district court found, and its finding is amply supported in the record, that taxpayer strictly enforced its discount policy.

For the years at issue, between 90% and 95% of taxpayer's customers took advantage of the discount, and 5% to 10% did not. By dollar volume, approximately 95% of the potential discounts were allowed by taxpayer, and approximately 5% either were not taken advantage of by the customer or were affirmatively disallowed by taxpayer. Of that 5%, between 15% and 20% were affirmatively disallowed, the balance of the customers having paid the full price without attempting to obtain the discount late. Thus, taxpayer affirmatively disallowed the discount in approximately 1% of the sales.

It is undisputed that most other competing cement manufacturers offered a discount with terms similar to those offered by taxpayer.

It is also undisputed that both the 1961 increase in the amount of the discount and the 1964 change in the terms of the discount were made by taxpayer at the same time the industry made similar changes and that taxpayer's changes were in response to competitive forces.

The government introduced evidence to support its argument that the terms of the discount were not essentially equivalent to interest, namely, that the discount did not represent a fair rate of interest for taxpayer to pay for the use of money, i. e., for the use of the prepaid discounted price. The government's witness, Mr. Townsend, testified that taxpayer's various discounts were equivalent to interest at an annualized rate ranging from 73% to 128%.[38] The

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[38] See defendant's exhibit 5, pp. 9–10, and Table 8.

witness determined the amount of the discount (e. g., 20¢ per barrel), and the discount percent[39] (e. g., on a sales price of $3.75 per barrel, the 20¢ per barrel discount represents a 5.3% discount.) The witness considered that taxpayer was paying an interest equivalence in the amount of the discount for use of the money — i. e., for the use of the prepaid discounted price — for the prepayment period — i. e., the length of time between the date by which the discounted price must be paid in order to obtain the discount and final due date of the account[40] (e. g., 20 days when the discount terms provided for payment of the discounted price by the 10th day of the month following shipment or payment of the full price by the end of that month.) Based on these determinations, Mr. Townsend calculated the annualized rate of interest represented thereby.[41] Mr. Townsend's calculations were based on the median mill price of bulk cement for taxpayer's various cement products. These prices did not include the 40¢ to 60¢ extra which would be reflected in taxpayer's sales of bagged cement, which were

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[39] We will use the shorthand term "discount percent" to refer to the percent of the sales price represented by the discount.

[40] We will refer to this time period by the shorthand term "prepayment period."

[41] Mr. Townsend's formula for the calculation was:

$$\frac{\text{discount \%}}{\text{(100 minus discount \%)}} \times \frac{365}{\text{prepayment period}}$$

An example of Mr. Townsend's calculation of the interest equivalence of a discount of 20¢ per barrel on a sales price of $3.75 per barrel with discount terms providing that the discounted price be paid by the 10th day of the month following shipment or the full price by the end of that month:

$$\frac{\text{5\% (rounded down from 5.3\%)}}{\text{(100 minus 5\%)}} \times \frac{365}{20} = 96\%$$

Thus, Mr. Townsend's testimony was that the 20¢ discount in the example was the equivalent of interest at an annualized rate of 96%. See defendant's exhibit 5, p. 10.

approximately 10% to 20% of taxpayer's sales. Nor did these mill prices include the freight charge which would have been included in a customer's invoiced delivered price. Taxpayer's official estimated that freight charges would range from 50¢ to 75¢ per barrel.

There was evidence that the most prevalent cash discount in the business community in general was the "2/10 net 30" discount. This discount entitled the customer to a 2% reduction if the discounted price is paid within 10 days, or the full price must be paid within 30 days. This "classic" discount represents an annualized interest rate of 37%.

Taxpayer asserts two purposes for its discount: to encourage prompt payment and to insure ultimate collection. Taxpayer argues that its discount is a cash discount which is entitled to a favorable treatment, which we explain as background for our discussion of the discount issue. Taxpayer argues that its full, undiscounted sales price should be included in the gross sales figure of the proportionate profits formula[42] and that the discount should be treated as an expense incurred by taxpayer for the benefit of the entire operation, thus to be allocated in part to the mining phase and in part to the nommining phase. The effect would be to increase the "gross sales" figure in the formula, thereby increasing "gross income from mining" and increasing taxpayer's percentage depletion deduction.

The government, on the other hand, argues that the effect of the treatment taxpayer seeks is to give taxpayer a percentage depletion deduction, based not only on the discounted sales price which it actually receives, but also on entitled to the favorable treatment taxpayer seeks. The the discount amount itself, which taxpayer does not receive.

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[42] The proportionate profits formula is:

$$\frac{\text{mining costs}}{\text{total costs}} \times \text{gross sales} = \text{gross income from mining}$$

The government argues that the appropriate treatment is to reduce the sales price by the discount, and thus include in the gross sales figure of the proportionate profits formula only the discounted price actually received.

The district court stated the issue as whether the discounts are cash discounts or trade discounts, and characterized the question as one of fact. Quoting from *Standard Lime,* the court distinguished cash discounts, which it described as discounts granted to encourage prompt payment, from trade discounts, which it described as discounts available without regard to the time of payment. The court held that the discounts at issue were cash discounts and entitled to the favorable treatment taxpayer seeks. The court divided its inquiry into two steps. First, the court found, as a matter of fact, that the actual policy and results of taxpayer's business were that the discounts were granted to induce prompt payment. Subsidiary supportive findings included:

> (1) Taxpayer offered the discount to induce early cash payment;
>
> (2) The discount was effective in collecting 90% to 95% of the accounts receivable;
>
> (3) Taxpayer strictly enforced the cash discount; and
>
> (4) Strict enforcement of the cash discount was achieved through close supervision of personnel who were allowed to give discounts.

In the second step of its inquiry, the district court held that the interest equivalency test, if applicable at all, was improperly applied by the government. The court rejected the government's interest equivalency test on the ground that the "prepayment period" used bf the government's witness was not supported in the evidence because collec-

tions often were not made until some time after the final due date.

The district court committed legal error in its holding that the government improperly applied the interest equivalency test. We hold that the government properly applied the test and that the district court's refusal to consider the interest equivalency factor was legal error. Assuming arguendo that the ultimate determination of the purpose of the discount and the classification as a cash discount or a trade discount is a question of fact,[43] we conclude that the discount at issue is a trade discount. Because the contrary conclusion, i.e., a determination that the discount is a cash discount, would be clearly erroneous on the facts of this case, we need not remand to the district court to make findings of fact applying the standards we set out.

We turn first to the interest equivalency test.[44] We hold that the proper "prepayment period" is, as the government urges, the time between the final due date of the account and the date by which the discounted price must be paid in order to be eligible for the discount. The Ninth Circuit so held in *California Portland.* Rev.Rul. 60-257 [45] so held. On the other hand, the court below cited no authority for its suggestion that the "prepayment period" should include

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[43] Because both parties in the instant case have treated this as a question of fact, we have assumed arguendo that it is, without deciding what is the appropriate standard for appellate review. See Wright and Miller, *Federal Practice and Procedure,* § 2589. See also *Suburban Realty Co. v. United States,* 615 F.2d 171 (5th Cir. 1980).

[44] Reg. 1.613–4(e) provides that the gross sales figure in the proportionate profits formula shall be reduced by cash discounts, as well as by trade discounts. However, this provision is applicable only to years beginning after November 30, 1968. Therefore, the regulation is not applicable to the taxable years in this case.

[45] 1960–2 C.B. 197.

the period during which any accounts were delinquent. We respectfully reject this suggestion of the district court, both on the basis of the authorities cited and because common sense points us to this conclusion. For example, if the final due date of an account is the last day of August, and the last date on which the discounted price can be paid is August 10, then it seems to us rather clear that both parties would ordinarily contemplate that the time period for which the prepaying customer would lose the use of his money, and conversely the extra time that the seller would have the use of the money, is the approximately 20 days between August 10 and the last day of August.

We further hold that there is no need for the district court on remand to reconsider the question of whether the discount here is substantially equivalent to a charge in the nature of interest for the use of the prepaid discounted price. The errors in the government's evidence, as pointed out by the taxpayer,[46] are not significant, and the evidence

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[46] Taxpayer argues that the government's expert witness, Mr. Townsend, used mill prices for bulk cement, whereas 10% to 20% of its sales, being sales of bagged cement, would have sold for 40¢ to 60¢ or more. Taxpayer also argues that Mr. Townsend's use of mill prices left out the freight charges which would have been included as part of the invoiced delivered price. In both cases, taxpayer argues that the average price would be increased, while the discount (e. g., 20¢ per barrel) would remain constant, thereby decreasing the discount percentage and thereby decreasing the interest equivalency of the discount. We have made calculations, adding both bagging and freight costs to the prices used by Mr. Townsend, and have concluded that the resulting change in the interest equivalency is not significant. The revised interest equivalency of the discount far exceeds the prevailing interest rate at the time. Taxpayer's own Vice President of Finance conceded as much.

Our calculations of the interest equivalency, taking into account the bag premium and the freight charges, indicate an annualized interest rate of 61.3% for January 1, 1960, to November 1, 1961; of 120.9% for November 1, 1961, to January 1, 1964; and of 86.3% for January 1, 1964, to December 31, 1968. We calculated these annualized rates using the Townsend formula.

in the record clearly shows that the discount represents an interest equivalence far in excess of the prevailing interest rate, which the record shows would range from 4% to 7%. Accordingly, we hold that the discount at issue is not substantially equivalent to a charge in the nature of interest.

The interest equivalency test is only one of the factors to weigh in determining whether a discount is a cash discount or a trade discount. We next examine the relevant authorities to flesh out the other factors, and articulate the standards to be applied in distinguishing cash from trade discounts.

Taxpayer relies primarily on *Standard Lime.*[47] Taxpayer asserts that *Standard Lime* involved the same discount that we must evaluate, that the government conceded it was a cash discount, and that the case is controlling. The discount in *Standard Lime* does appear identical to the one at issue here for the taxable year 1960 and part of 1961. However, because the government conceded that the discount was a cash discount, the discussion of the Court of Claims is dictum. We need not consider the precedential value, if any, of the government's concession because Rev. Rul. 60-257, clarifying the Internal Revenue Service position on cash discounts, was prospective only, to apply only

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We took the median mill price for bulk cement per barrel from Table 8, Def.Ex. 5. Table 8 reflects a median mill price of $3.55 per barrel in 1964, $3.60 in 1965 and 1966, and $3.75 in 1967 and 1968. To give the taxpayer the benefit of any doubt, we used the highest figure. We added a 50¢ per barrel bag premium for 15% of the sales and a 60¢ per barrel freight charge.

[47] The other two cases, cited by taxpayer, *Riverside Cement Co. v. United States,* 2 A.F.T. R.2d 6175 (S.D.Cal.1958), and *California Portland Cement Co. v. Riddell,* 3 A.F.T.R.2d 438 (S.D.Cal.1958), *rev'd and remanded on other issues,* 297 F.2d 345 (9th Cir. 1962), are cryptic district court cases both of which find, in conclusory fashion, that primary purpose of the discount is prompt payment, and conclude that the discount is a cash discount without citation of authority or anaylsis. We accord them little weight.

to taxable years after January 1, 1960. The government's concession in *Standard Lime* related to the taxable year 1954, and the Internal Revenue Service had served notice that it would apply the stricter standard of Rev.Rul. 60-257 beginning in 1960.[48]

*Standard Lime* also distinguishes cash discounts from trade discounts, saying that the former are granted to encourage prompt payment and are optional with the customer, while the latter are granted at the option of the seller and do not depend upon when payment is made. As note above, this definition is dictum. Our analysis leads us to the conclusion that this is only one[49] of several factors to be weighed in the determination of whether a discount is a cash discount entitled to the favorable tax treatment which taxpayer seeks.

**[4]** *Standard Lime* also stated that "trade discounts are deemed reductions in the sales price thus not includable in taxpayer's gross income." 329 F.2d at 947, n.18. This statement comports with our understanding of the law.[50]

In *California Portland* the Ninth Circuit dealt with the discount issue in the cement industry. The court held that a discount very similar[51] to the one at issue was a trade

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[48] In Rev.Rul. 60–257, the Service noted that the determination of cash discount status had strayed in some instances from the strict determination of whether the discount represented a fair interest rate to a less strict standard of whether the discount was a reasonable one in light of customary trade practices. The Service ruled prospectively that in determining gross income from mining, gross sales should be reduced by any prepayment discount "unless the discount is a cash discount and one that under all the circumstances is substantially equivalent to a charge in the nature of interest for the use of the net amount paid in advance of the date when it was otherwise due and payable." 1960–1 C.B. at 198.

[49] This is the first factor discussed below as favorable to taxpayer.

[50] Accord *California Portland;* Rev.Rul. 60–257, 1960–2 C.B. 197.

[51] Five and one-half percent discount (20¢ on sales price of $3.63) for a "prepayment period" of about 20 days. 413 F.2d 174, 175.

discount, and not a cash discount, entitled to the favorable treatment taxpayer urges. The court below had made a finding of fact, very similar to that in the instant case, that the purpose of discount was to induce prompt payment and that the discount was a cash discount. The Ninth Circuit found that the discount — calculated in the same manner as the interest equivalency has been determined in the instant case — did not represent a fair interest rate. The court concluded on the basis of that fact, plus the fact that the discount was rarely disallowed, plus the fact that the same discount was prevalent in the industry, that the discount was a trade discount and not a cash discount.

Taxpayer argues that *California Portland* can be distinguished because the discount there was rarely disallowed. Only .03% of the discounts there were disallowed, compared to approximately 5%, by dollar volume, in the instant case. We do not find this difference sufficient to distinguish *California Portland;* we consider the discounts disallowed in the instant case to be small in comparison to the total discounts available.

Taxpayer next argues that *California Portland* is distinguishable on the basis of the substantial evidence in our case that General Portland strictly enforced its discount policy. We note that the Ninth Circuit did not indicate whether or not the discount policy was strictly enforced; it noted only that in one of the taxable years there involved discounts of only $347 were disallowed while $1,000,000 in discounts were allowed. Nevertheless, we do consider the demonstrated strict enforcement of taxpayer's discount policy to be an important factor favoring the taxpayer's position, and providing some evidence that the discount was not a disguised price reduction for competitive purposes. We will weigh this factor in taxpayer's favor in our application of the legal standards to the facts of this case.

In Rev.Rul. 60-257 the Internal Revenue Service ruled that:

> [I]n determining 'gross income from the property' for percentage depletion purposes the gross selling price should be reduced by the amount of any prepayment discount allowed by the taxpayer and utilized by the purchaser unless the discount is a cash discount and one that under all the circumstances is substantially equivalent to a charge in the nature of interest for the use of the net amount paid in advance of the date when it was otherwise due and payable.

1960 — 2 C.B. at 198. The ruling clarified the earlier Rev.Rul. 55 — 13[52] and clarified the acquiescence in *Montreal Mining Company v. Commissioner*, 2 T.C. 688 (1943), acq. 1944 C.B. 20. The ruling approved the result in *Montreal Mining* because the discount there constituted in substance a payment by the taxpayer for the use of the net purchase price for time period of the prepayment, and represented a fair interest rate.[53] The Ruling pointed out that to allow the favored treatment to a discount which did not reflect a fair rate of interest would be to allow taxpayer percentage depletion on amounts to which taxpayer was never entitled and could never collect.

We note that the ruling requires that the discount be *both* a cash discount and one which is substantially equivalent to interest. As our analysis in the next two paragraphs indicates, we do consider interest equivalency to be an important factor, but we do not adopt the ruling's position that interest equivalency is a prerequisite.

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[52] 1955–1 C.B. 285.

[53] The discounts in *Montreal Mining* were computed at an annualized rate of 5% or 6%. It was found that these rates were higher than the prevailing rate at that time, but were nevertheless a fair interest rate. 2 T.C. at 691, 697.

We turn now to analyze the cash discount at issue and the favorable treatment taxpayer seeks, in light of the purpose behind the percentage depletion deduction. We can see that it is reasonable to treat as an expense a payment for the use of money for the "prepayment period." This is substantially equivalent to a simple bank loan by taxpayer, secured by his account receivable and repayable when the account receivable is due. Such interest would be an expense allocated between the mining and nonmining phases. In the bank loan situation, of course, the full account receivable is received and would be included in the gross sales figure. To the extent that the substance of a discount situation is like the bank loan, the treatment taxpayer seeks is proper. Rev.Rul. 60—257 so holds. Thus, we conclude that if a cash discount were essentially equivalent to interest, taxpayer's treatment would comport with the purpose of percentage depletion.

However, we are not convinced that a discount, to qualify for the favorable treatment, must be approximately equal to the prevailing interest rate. We concede to the government that a taxpayer, using good business judgment, would not pay more than the prevailing interest rate just to encourage customers to pay 20 days early. The taxpayer here, however, asserts an additional purpose, i. e., to insure ultimate collection. We conceive that a cement manufacturer might be willing to offer a discount which reflects a rate of interest somewhat higher[54] than the prevailing interest rate in order to encourage customers to pay their

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[54] We need not decide in this case what size discount is necessary or appropriate to serve the purpose of insuring ultimate collection. The only evidence in this record bearing on this subject is the evidence of the classic "2/10 net 30" discount which represents an annualized interest rate of 37%. We express no opinion as to the appropriateness of that discount, but we note that taxpayer's discount far exceeds 37%, and that taxpayer has introduced no evidence to demonstrate why it was necessary to have such a large discount to accomplish its legitimate purpose.

bills. The manufacturer may well deem the monetary sacrifice for prompt and early payment reasonable in the construction trade where contractors often experience cash flow difficulties. Sometimes the early bird is the only one who gets a worm. A discount for the sole purpose of ultimate collection, like expenses for credit reports and other collection expenses and like interest expenses, would properly receive the favorable treatment taxpayer seeks. Such a discount would in substance be the same as if taxpayer did receive the full, undiscounted sales price, but then incurred a financial expense to ensure collection.

Applying the above principles to the facts of the instant case, we consider that three facts are potentially favorable to taxpayer: (1) the fact that the discount was tied to prompt payment; (2) the fact that the discount policy was effective in accomplishing the prompt collection of approximately 95% of taxpayer's collections; and (3) the fact that the policy was strictly enforced.

The first fact, the tie to prompt payment, is of course a prerequisite, but it does not foreclose the possibility that the discount might also serve a significant, competitive price-reducing function. *California Portland* so holds.

Similarly, the second fact is not persuasive. Although it is obvious that the larger the discount, the more effectively it will encourage prompt payment, it is also obvious that the larger the discount, the greater the likelihood it also serves a competitive price-reducing function.

The third fact provides the basis of taxpayer's strongest argument. It is true, as taxpayer urges, that strict enforcement of the discount policy could operate in a manner adverse to taxpayer's competitive interests. If taxpayer strictly enforces its discount policy, as the evidence demonstrates, and taxpayer's competitors do not, taxpayer's competitive position is hurt. Although we do consider this to be an important factor in favor of taxpayer's position, we

will weigh this factor, keeping in mind that any adverse competitive impact would be confined to the approximately five percent of taxpayer's sales with regard to which the discount was not allowed. Even within this 5%, the record shows that the discount was affirmatively disallowed in only 15% to 20% of those sales, while the customer simply mailed in the full price in the balance of the sales. Thus, taxpayer affirmatively disallowed the discount in only approximately 1% of its sales.

The factors favoring the government's position are: (1) the large size of the discount; (2) the small number of sales in which the discount was not actually allowed to customers; (3) the prevalence in the industry of the same discount; and (4) the record evidence demonstrating that taxpayer's changes in its discount terms resulted from competitive forces.

First,[55] the discount at issue far exceeds the prevailing interest rate. Thus, it seems unlikely that taxpayer would pay a discount of this size merely to accelerate its collections, when taxpayer could have obtained, at a fraction of the cost, a bank loan pending payment of the accounts at the final due date. With regard to taxpayer's other stated purpose for its discount policy — to secure ultimate collection — there is no evidence in the record to explain why taxpayer had to offer a discount so large to accomplish this purpose. The record does reveal that the most prevalent cash discount in business is the "2/10 net 30" discount. Taxpayer's discount far exceeds the classic discount. Taxpayer has not demonstrated that its discount is in substance a

[55] Whether or not the discount fluctuated with fluctuations in the interest rate would also be relevant. Changes in the discount to reflect changes in interest rates would provide some evidence of interest equivalency. In the instant case there is no evidence of such a relationship. However, because interest rates changed so slightly during the years at issue (see defendant's Exhibit 5, Table 7), we assign no significance to the absence of changes in the discount in response to changes in the prevailing interest rates.

financial expense incurred either to encourage prompt payment or to insure ultimate collection. Such a large discount carries implications that the discount is serving not only a collection purpose, but also a competitive price-reducing purpose.

Second, the fact that only approximately 5% of taxpayer's sales, by dollar volume, did not in fact take advantage of the discount means that, for all practical purposes the effective price of taxpayer's products was the discounted price.

Third, the prevalence in the industry of the same discount constitutes an implication that the discount has a competitive purpose and effect.

Fourth, the evidence in the record demonstrates that both the 1961 increase in the amount of the discount, and the 1964 change of terms — lengthening the time to pay the discounted price and the time to pay the full price — were in response to competitive forces. While the third factor provides only an implication, this fourth factor is concrete evidence that both the size and the terms of the discount at issue were influenced by competitive forces.

The determination of whether a discount is a cash discount or a trade discount must be made upon consideration of all the facts and circumstances and in light of the purpose of the percentage depletion deduction. In this case, the factors listed and discussed above are the relevant factors. The district court considered only the three factors listed above as favoring the taxpayer; we hold that the district court committed legal error in failing to consider the four factors listed above as favorable to the government. Although we reverse the district court for failure to apply the proper legal standards, we find no need for the court below to review the facts in light of these standards, because we hold that it would have been clearly erroneous on the facts in this record to find that the discount at issue did not have

a significant competitive price reducing purpose and effect. Weighing the facts,[56] we conclude that the discount at issue — while it did serve effectively to encourage prompt payment and perhaps also ultimate collection — also had a significant competitive price reducing purpose and effect. This conclusion is fatal to taxpayer's case. To allow taxpayer the favorable tax treatment it seeks for the discount at issue would be to allow a deduction for amounts that do not fit within the two categories of legitimate deductions asserted by taxpayer, i.e., interest expenses and collection expenses. To allow the favorable treatment to this discount, which reflects in significant part a competitive price reduction, would be to grant taxpayer a windfall, a percentage depletion deduction based not only on the reduced sales price actually received by taxpayer, but also on the discount amount itself which taxpayer does not receive and which taxpayer has failed to demonstrate is the equivalent of a deductible interest or collection expense. We hold that taxpayer has failed to carry its burden of proving that its discount comes within the purpose of the percentage depletion deduction, which like any other tax deduction is a matter of legislative grace and must be narrowly construed.

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[56] We need not today decide precisely what weight to accord to each factor. We do, however, reject the position of Rev.Rul. 60-257 which makes interest equivalency a prerequisite, because a discount somewhat larger than one equivalent to interest is probably required to serve taxpayer's legitimate interest in insuring ultimate collection. However, it may well be proper to impose as a prerequisite that taxpayer prove its discount is no larger than is necessary or appropriate to serve its legitimate purposes, i.e., encouraging prompt payment and ultimate collection. We need not decide that question today, because in the instant case the taxpayer has not only failed in that proof, but also has arrayed against it the concrete evidence that its discount was influenced by competitive forces, and the fact that the discounted price was the effective price in approximately 95% of taxpayer's business.

Accordingly, we hold that, for purposes of the percentage depletion deduction, the discounts[57] at issue are trade discounts, and should not be included in the gross sales figure of the proportionate profits formula.[58]

## V. INTEREST ISSUE

[5] For the years 1960 through 1964, taxpayer incurred interest expenses totaling $3,236,927.84. The interest expenses were primarily attributable to interest on $15 million in debentures issued by taxpayer in 1957. In the same years, taxpayer had interest income totaling $1,519,447.71. The interest income was primarily attributable to short term investments in Treasury bills and commercial paper.

The interest issue before us is whether the taxpayer may reduce his interest expense deduction by the amount of interest income earned on the borrowed funds. This issue does not involve the proportionate profits method; nor is it involved in the determination of "gross income from mining." Rather, the issue involves a separate limitation on the percentage depletion deduction. Section 613(a) provides that the percentage depletion deduction "shall not exceed 50% of the taxpayer's taxable income from the property (computed without allowance for depletion)." The regulations provide,[59] and the parties agree, that "tax-

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[57] Of course, in those instances when taxpayer actually receives the full undiscounted price, taxpayer should receive its percentage depletion deduction on the full price.

[58] We do not address taxpayer's alternative argument – that it should be entitled to reduce the 1968 year-end accounts receivable, and therefore the 1968 gross income, by the amount of the unearned discounts – because the issue was not addressed by the court below and on appeal the issue is merely raised in brief without discussion or citation of authority. We prefer for the district court on remand to consider this issue in the first instance, as well as, of course, the government's arguments in opposition.

[59] Treas.Reg. 1.613–5(a).

able income from the property" is computed by subtracting from "gross income from mining" certain expenses, including that portion of the interest expense properly allocable to the mining phase. There is no dispute between the parties as to the proper method of allocation. The dispute is whether the proper interest expense figure is the full $3,236,927.84 or the net interest expense of $1,717,480.13, obtained by netting the interest income of $1,519,447.71 against the total interest expense. It is apparent that if the interest expense figure is reduced, as taxpayer urges, the "taxable income from the property" will be increased, thus increasing the "50% limit" and taxpayer's percentage depletion deduction.

The district court held that taxpayer is entitled to reduce its interest expense by the interest income earned on the borrowed funds.

Apparently only one case has addressed this narrow issue.[60] The government relies heavily upon *Island Creek Coal Company v. Commissioner*, 30 T.C. 370 (1958) [hereinafter referred to as *Island Creek*]. There the taxpayer realized income on the sale of certain scrap items, including steel, wire, etc. These scrap items represented waste from supplies which had originally been charged to the production costs of the mine. The taxpayer sought to set this income from its scrap salvage operations off against its current supplies and maintenance account, thus reducing that account and increasing its "taxable income from the property." The Tax Court rejected taxpayer's attempt. Relying upon cases which had refused taxpayer attempts

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[60] Other cases cited by the government or by the *Island Creek* court simply hold that items of income which are extraneous to the mining operations are not included in "gross income from the property." *Guthrie v. United States*, 323 F.2d 142 (6th Cir. 1963); *Big Four Oil and Gas Co. v. United States*, 118 F.Supp. 958 (W.D.Pa. 1954); *Estate of Thomas E. Arnett v. Comm'r*, 31 T.C. 320, 335-6 (1958); *Monroe Coal Mining Co. v. Comm'r*, 7 T.C. 1334 (1946).

to include in "gross income from mining" income from sources extraneous to the mining operation, and saying that the income from the scrap salvage operations was not income attributable to the mining operations and that the taxpayer could not do by indirection that which he was prevented from doing directly, the Tax Court rebuffed taxpayer's attempt to offset its scrap income against its expense of supplies.

The government and the taxpayer in this case agree, and this court agrees, that "gross income from mining" does not include income items extraneous to the mining operations. The Tax Court in *Island Creek* leapt from this truism to the conclusion that an income item could not be offset against an expense account. The Tax Court set forth no reasons or analysis other than "it is axiomatic that a taxpayer may not do by indirection that which it may not do directly." 30 T.C. at 384. Although we agree that taxpayer cannot include its interest income in "gross income from mining," we do not agree that the taxpayer here is seeking to accomplish that result by indirection. Whether taxpayer's interest income is part of "gross income from mining" is not, we submit, the same question as whether taxpayer's interest income is related to its actual cost for interest on borrowed funds. We cannot so easily conclude that an item, just because it is an income item under technical accounting principles, can never be an offset against an expense item. We think the purpose behind the "50% limit" argues in favor of the taxpayer in the instant case. We believe that purpose is served by subtracting the *actual* cost of interest, rather than an inflated amount. Taxpayer's actual cost of interest is its "net" interest expense. The taxpayer would not have derived the interest income had it not first incurred its interest expense. An example will reinforce our reasoning. Assume that a mining company bought, or brought to its laboratory on approval, ten aprons

for the use of its laboratory personnel. Assume further that nine were kept, and one was returned. Even if the return of the tenth apron would give rise to a refund which under the company's accounting practices would be an income item, it seems clear to us that the actual cost incurred for aprons is for nine, not ten.

On the basis of the above analysis, we decline to follow the implication in *Island Creek* that a technical income item can never offset an expense item.[61] We hold that taxpayer's actual interest cost is the net amount, and that taxpayer can offset its interest income against its interest expense in calculating "taxable income from the property" for purposes of the "50% limit."

Accordingly, we affirm in part, reverse in part, and remand.[62]

AFFIRMED IN PART, REVERSED IN PART, AND REMANDED IN PART.

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[61] *Island Creek* can be distinguished because the income at issue there was generated from a separate scrap salvage operation which salvaged waste materials that had already been used. Such income is different from the refund "income" attributable to the returned apron in the hypothetical discussed in the text and different from the interest income in the instant case. We need not decide today how we would have decided the *Island Creek* case; we decide today only that taxpayer's actual cost for the use of money is the "net" interest expense, and that taxpayer in this case can set off its interest income against its interest expense in computing the "50% limit" to its percentage depletion deduction. We decide today only that *Island Creek* will not be *extended* to require a result which we would consider inequitable and in violation of the purpose behind the "50% limit."

[62] On remand the district court can consider taxpayer's alternative argument mentioned above in Part IV, n.58.

## APPENDIX C

Treasury Regulations 118 (1953):

*§39.23(m)-1 Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*

* * * * *

(e) As used in sections 114(b)(3) and 114(b)(4)(A) and §§ 39.23(m)-1 to 39.23(m)-19, inclusive, the term "gross income from the property" means the following:

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(3) If the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine, "gross income from the property" means the amount for which such product was sold, but, if the product is transported or processed (other than by the ordinary treatment processes described below) before sale, "gross income from the property" means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product (other than transportation treated, for the taxable year, as mining). If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude mineral state is merely transported, the price for which sold) minus the costs and proportionate profits attributable to the transportation (other than transportation treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes.

If the taxpayer establishes to the satisfaction of the Commissioner that another method of computation, other than the computation of profits proportionate to costs, clearly reflects the gross income from the property, then such gross income shall be computed by the use of such other method.

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Treasury Regulations on Income Tax (1968), 26 C.F.R.

§ 1.613-3. *Gross income from the property.*

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(d) *Sales after the application of nonmining processes where a representative market or field price cannot be ascertained — (1) Computation of gross income from the property by use of the proportionate profits method.*

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(iii) Those costs which are paid or incurred by the taxpayer to produce, sell, and transport the first marketable product or group of products, and which are not directly identifiable with either a particular mining process or a particular nonmining process shall be properly apportioned to mining and to nonmining. In the absence of any specific provision of this section providing an apportionment method, such costs shall be apportioned by use of a method which is reasonable in the circumstances. One method which may be reasonable in a particular case is an allocation based on the proportion that the direct costs of mining processes and the direct costs of nonmining processes bear to each other. For example, the salary of a corporate officer engaged in overseeing all of the taxpayer's processes is an expense which would normally be apportioned on the basis of the ratio between the direct

costs of mining and nonmining processes. On the other hand, an expense such as workmen's compensation premiums would normally be apportioned on the basis of direct labor costs. For the rule relating to selling expenses, see paragraph (c) of § 1.613-4.

(iv) As used in this section, the term "first marketable product or group of products" means the product (or group of essentially the same products) produced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing area. For this purpose, bulk and packaged products are considered to be essentially the same product. The first marketable product or group of products does not include a product or group of products additionally refined, beneficiated, altered, or manufactured as a result of the application of additional nonmining processes. For example, if a cement manufacturer sells his own finished cement of various types in bulk and bags and also sells concrete blocks or dry ready-mix aggregates containing additives, the finished cement of various types, in bulk and bags, constitutes the first marketable product or group of products produced by him. Similarly, if an integrated iron ore and steel producer sells both pig iron in various sizes and rolled sheet iron or shapes, his first marketable product is the pig iron in its various sizes. Further, if an integrated clay and brick producer sells both unglazed bricks and tiles of various shapes and sizes and additionally manufactured bricks and tiles which are specially glazed, the unglazed products, both packaged and unpackaged, constitute his first marketable product or group of products.

(v) As used in this paragraph, the term "gross sales (actual or constructive)" means the total of the taxpayer's actual sales to others of the first marketable product or group of products, plus the taxpayer's constructive sales of the first marketable product or group of products used or retained for use in his own subsequent operations. The prices at which actual or constructive sales are made are to be determined in accordance with the principles set forth in this paragraph and in paragraphs (b), (c), and (e) of this section, as appropriate. In the case of constructive sales of the taxpayer's first marketable product or group of products, the taxpayer shall attach to his return a statement indicating the price or prices used by him in computing the representative market or field price for such product or products, and the source of his information as to such price or prices. The prices at which actual or constructive sales are made shall not be determined by reference to prices established in transactions between members of a controlled group. See paragraph (a) of § 1.482-1 for the definitions of the terms "controlled" and "group".

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(4) *Treatment of particular items in computing gross income from the property by use of the proportionate profits method or another approved method based on the taxpayer's costs.* (i) Except as specifically provided elsewhere in this section, when determining gross income from the property by use of the proportionate profits method or any other approved method which is based on the taxpayer's costs, the costs attributable to mining transportation shall be treated as mining costs, and the costs attributable to nonmining transportation shall be treated as nonmining costs. Accordingly, except as specifically provided elsewhere

in this section, all profits attributable to mining transportation shall be treated as mining profits, and all profits attributable to nonmining transportation shall be treated as nonmining profits. For this purpose, mining transportation means so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to plants or mills in which other mining processes are applied thereto as is not in excess of 50 miles or, if the taxpayer files an application pursuant to paragraph (h) of this section and the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over the greater distance. Further, for this purpose, nonmining transportation includes the transportation (whether or not by common carrier) of ores, minerals, or the products produced therefrom, from the point of extraction from the ground to nonmining facilities, or from a mining facility to a nonmining facility, or from one nonmining facility to another, or from a nonmining facility to the customers who purchase the taxpayer's first marketable product or group of products. See paragraph (e)(2) of this section for provisions relating to purchased transportation to the customer, and paragraph (g)(3) of this section for provisions relating to transportation the primary purpose of which is marketing or distribution. In the absence of other methods which the district director determines will clearly reflect the costs of the various phases of transportation, the cost attributable to nonmining transportation shall be an amount which is in the same ratio to the costs incurred for the total transportation as the distance of the nonmining transportation is to the distance of the total transportation.

Where the plants or mills in which mining processes are applied to ores or minerals are in excess of 50 miles from the point of extraction from the ground (or in excess of a greater distance approved by the Commissioner), the costs incurred for transportation to such plants or mills in excess of 50 miles (or of such greater distance) shall be treated as nonmining costs in determining gross income from mining. Accordingly, all profits attributable to such excess transportation are treated as nonmining profits. However, except in the case of transportation performed in conveyances owned or leased by the taxpayer, the preceding sentence shall apply only to taxable years beginning after November 30, 1968.

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(iii) In determining gross income from the property by use of the proportionate profits method (or any other approved method which is based on the taxpayer's costs) —

(a) The costs attributable to containers, bags, packages, pallets, and similar items as well as the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

(b) The costs attributable to the bulk loading of manufactured products shall be considered as nonmining costs.

(c) The costs attributable to the operation of warehouses or distribution terminals for manufactured products shall be considered as nonmining costs.

Accordingly, all profits attributable thereto are treated as nonmining profits.

(iv) In computing gross income from the property by means of the proportionate profits method or any other approved method based on the taxpayer's costs, the principles set forth in paragraph (c) of § 1.613-4 shall apply when determining whether selling expenses and trade association dues are to be treated, in whole or in part, as mining costs or as nonmining costs. To the extent that selling expenses and trade association dues are treated as nonmining costs, all profits attributable thereto are treated as nonmining profits.

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(e) *Reductions of sales price in computing gross income from the property*— * * *

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(2) *Purchased transportation to the customer.****

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(ii) In the case of a taxpayer computing gross income from mining under the provisions of paragraph (d)(1) of this section, the cost of purchased transportation to the customer (as defined in subdivision (iii) of this subparagraph) shall be excluded from the taxpayer's gross sales of his first marketable product or group of products (after any adjustments required by subparagraph (1) of this paragraph) and from the denominator of the proportionate profits fraction, without attributing profits to the cost of such transportation. Similar transportation cost adjustments may be made, if appropriate, in the case of methods of computation which are approved under paragraph (d)(2) of this section and which are based on the taxpayer's costs. For the treatment of costs and profits attributable to transportation which does not meet the requirements of subdivision (iii) of this subparagraph, see paragraph (d)(4)(i) of this section.

(iii) For purposes of this section, the term "purchased transportation to the customer" means, in gen-

eral, nonmining transportation from the taxpayer's mine or plant to the customer —

(a) Which is performed in conveyances owned or leased by persons other than the taxpayer, rather than in conveyances owned or leased by the taxpayer;

(b) Which is performed solely to deliver the taxpayer's minerals or mineral products to the customer, rather than to transport such minerals or products for packaging or other additional processing by the taxpayer (other than incidental storage or handling); and

(c) Which is charged to the customer in such a way that the taxpayer ordinarily does not earn any profit with respect to such transportation.

For purposes of the preceding sentence, transportation which is performed by a person controlling or controlled by the taxpayer (within the meaning of paragraph (a)(3) of § 1.482-1) shall be deemed to have been performed in conveyances owned or leased by the taxpayer unless it is established by the taxpayer that the price charged by the controlling or controlled person for such transportation constitutes an arm's-length charge (under the standard described in paragraph (b)(1) of § 1.482-1). The term "purchased transportation to the customer" includes transportation to a warehouse, terminal, or distribution facility owned or operated by the taxpayer, provided that such transportation is performed under the conditions described in the first sentence of this subdivision. The taxpayer must demonstrate the nonprofit character of the transportation services, as described in (c) of this subdivision, in light of all the facts and circumstances. It shall be presumed that the requirements set forth in either (a) or (c) of this subdivision (relating, respectively, to conveyance ownership and profits) are not satisfied

if the taxpayer requires customers to purchase minerals or mineral products only on a delivered basis, by failing to offer such minerals or products for sale on the basis of a price f.o.b. the taxpayer's mine or plant, or by other means. In the case of taxpayers computing gross income from mining under the provisions of paragraph (d) of this section, the term "purchased transportation to the customer" refers to transportation which conforms with the other requirements of this subdivision and which is performed to transport the taxpayer's first marketable product or group of products (as defined in paragraph (d)(1)(iv) of this section) rather than to transport minerals or mineral products which do not yet constitute the taxpayer's first marketable product or group of products.

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(g) *Nonmining processes*—***

* * * * *

(3) *Transportation for the purpose of marketing or distribution; storage.* Transportation the primary purpose of which is marketing, distribution, or delivery for the application of only nonmining processes shall not be considered as mining. Nor shall transportation be considered as mining merely because, during the course of such transportation, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow. Similarly, storage or warehousing of manufactured products shall not be considered as mining. The preceding sentence shall apply even though, during the course of such storage or warehousing, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow.

* * * * *